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PRIVATELY FINANCED INFRASTRUCTURE PROJECTS

Draft chapters of a legislative guide on privately financed infrastructure projects

Report of the Secretary-General

Addendum

V. INFRASTRUCTURE DEVELOPMENT AND OPERATION

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LEGISLATIVE RECOMMENDATIONS

1. Subcontracting (see paras. 2-4)

1. The host country may wish to provide:

(a) That the concessionaire should have the right to enter into contracts, as necessary, for the execution of public works and the operation and maintenance of the infrastructure facility. The contracting authority should be advised of the names and qualifications of the subcontractors engaged by the concessionaire;

(b) That, notwithstanding the above, the contracting authority may reserve the right to review and approve contracts entered into by the concessionaire with its own shareholders or affiliated persons. The contracting authority's approval should not normally be withheld except where the contracts contain provisions manifestly contrary to the public interest or to mandatory rules of a public law nature.

2. Construction projects (see paras. 5-17)

2. The host country may wish to provide:

(a) That, where appropriate, the project agreement should set forth the procedures for the review and approval of construction plans and specifications by the contracting authority;

(b) That the project agreement should set forth the specific circumstances under which the contracting authority may order variations in respect of construction terms; the compensation that may be due to the concessionaire, as appropriate, to cover the additional cost entailed by the variations; the procedures for ascertaining and liquidating such costs; and the circumstances and amounts beyond which the concessionaire should no longer be under an obligation to implement the variations;

(c) That the contracting authority may, as appropriate, reserve the right to monitor the construction of, or improvements to, the infrastructure facility to ensure that they conform to the engineering standards acceptable to the contracting authority. Any suspension of the project ordered by the contracting authority should not exceed the time necessary, taking into consideration the circumstances that gave rise to the requirement to suspend the project;

(d) That the project agreements should set forth the procedures for testing and final inspection of the facility, its equipment and appurtenances. Where the law requires that the facility be accepted by the contracting authority, such acceptance should not be denied unless the work is found to be incomplete or defective.

3. Infrastructure operation (see paras. 18-46)

3. The host country may wish to provide that the project agreement should set forth, as appropriate, the extent of the concessionaire's obligations to ensure:

(a) The expansion of the service so as to meet the demand of the community or territory served;

(b) The continuity of the service, except where the provision of the service is rendered impossible by an exempting impediment, as provided in the project agreement;

(c) The availability of the service under essentially the same conditions to all users, except for reasonable differentiation between categories of users that are based on objective grounds, as provided in the project agreement;

(d) The non-discriminatory access, as appropriate, of other service providers to any public infrastructure network operated by the concessionaire, under the terms and conditions established in the project agreement.

4. Where the prices charged by the concessionaire are subject to external control by a regulatory body, the host country may wish to provide that the project agreement should set forth the mechanisms for periodic or extraordinary revisions of the price adjustment formulas.

5. The host country may wish to provide that the project agreement should set forth:

(a) The extent of the concessionaire's obligation to provide the contracting authority or a regulatory body, as appropriate, with reports and other information on its operations;

(b) The procedures for monitoring the concessionaire's performance and for the taking of such reasonable actions as the contracting authority may find appropriate, to ensure that the infrastructure facility is properly maintained and the services are provided in accordance with the applicable legal and contractual requirements.

6. The host country may wish to provide that, subject to the approval of the contracting authority, the concessionaire may issue and enforce rules governing the use of the facility.

4. Guarantees of performance and insurance (see paras. 47-58)

7. The host country may wish to provide that the project agreement should set forth:

(a) The forms, duration and amounts of the guarantees of performance that the concessionaire may be required to provide in connection with the construction and the operation of the facilities;

(b) The forms and amounts of the insurance policies that the concessionaire may be required to maintain to ensure coverage of workers' compensation, environmental damage, tort liability to the public and employees, property damage and other insurance that may be required to enable the continued operation of the facility.

5. Changes in conditions (see paras. 59-68)

8. The host country may wish to provide that the project agreement should set forth the mechanisms for revising the terms of the project agreement following the occurrence of legislative changes that affect specifically the particular project, or a class of similar projects, or privately financed infrastructure projects in general, or other changes in the economic or financial conditions that, without preventing the performance of the obligations assumed by the concessionaire, render the performance of the obligation substantially more onerous than originally foreseen.

6. Exemption provisions (see paras. 69-79)

9. The host country may wish to provide that the project agreement should set forth the circumstances under which either party may be exempt from liability for failure or delay in complying with any obligation under the project agreement, to the extent that such failure or delay has been caused by an occurrence beyond their reasonable control that causes either party to be unable to perform its obligation and that the party has been unable to overcome by the exercise of due diligence.

7. Events of default and remedies (see paras. 80-91)

10. The host country may wish to provide that the project agreement should set forth the remedies available to the contracting authority and the concessionaire in the event of default by the other party.

11. The host country may wish in particular to provide:

(a) That, in the event of serious failure by the concessionaire to perform its obligations under the project agreement, the contracting authority may temporarily take over the operation of the facility for the purpose of ensuring the effective and uninterrupted delivery of the service;

(b) That the contracting authority may enter into agreements with the lenders allowing them to appoint a new concessionaire to perform under the existing project agreement if the concessionaire seriously fails to deliver the service required under the project agreement or if other specified events occur that could justify the termination of the project agreement.

NOTES ON THE LEGISLATIVE RECOMMENDATIONS

A. General remarks

1. The conditions under which infrastructure is developed and operated may vary considerably from project to project and, therefore, it is generally not advisable to attempt to regulate by means of general legislation specific aspects of the mutual rights and obligations of the concessionaire and the contracting authority. However, in most infrastructure projects there will be issues that might need to be considered by the legislature. The contracting authority might need to be provided, for instance, with specific powers to enter into the necessary contractual arrangements for addressing certain issues in a suitable fashion. Furthermore, the Government may have an interest in ensuring predictability and coherence in the treatment of certain recurrent issues relating to the execution of privately financed infrastructure projects.

B. Subcontracting

2. Given the complexity of infrastructure projects, the concessionaire typically retains the services of one or more construction contractors for performing some or the bulk of the construction work under the project agreement. Furthermore, the concessionaire may also wish to retain the services of contractors with experience in the operation and maintenance of infrastructure during the operational phase of the project. The laws of some countries generally acknowledge the concessionaire's faculty to enter into contracts as needed for the execution of the construction work. A legislative provision recognizing the concessionaire's authority to subcontract may be particularly useful in countries where there are limitations to the ability of Government contractors to subcontract.

3. The concessionaire's freedom to hire subcontractors is in some countries restricted by rules that prescribe the use of tendering and similar procedures for the award of subcontracts by public service providers. Such statutory rules have often been adopted when infrastructure facilities were primarily or exclusively operated by the Government, with little or only marginal private sector investment. The purpose of such statutory rules was to ensure economy, efficiency, integrity and transparency in the use of public funds. However, in the case of privately financed infrastructure projects, there may no longer be a compelling reason of public interest for prescribing to the concessionaire the procedure to be followed for the award of its contracts. On the contrary, such provisions may discourage the participation of potential investors, since the project sponsors typically include engineering and construction companies that participate in the project in the expectation that they will be given the main contracts for the execution of the construction and other work.

4. The concessionaire's freedom to select its subcontractors is not unlimited, however. In some countries, the concessionaire has to identify in its proposal which contractors will be retained, including information on their technical capability and financial standing. Other countries either require that such information be provided at the time the project agreement is concluded or subject such contracts to prior review and approval by the contracting authority. The purpose of such provisions is to avoid possible conflicts of interest between the project company and its shareholders, a point that would normally also be of interest to the lenders, who may wish to ensure that the project company's contractors are not overpaid. In any event, if it is deemed necessary for the contracting authority to have the right to review and approve the project company's subcontracts, the project agreement should clearly define the purpose of such review and approval procedures and the circumstances under which the contracting authority's approval may be withheld. As a general rule, approval should not normally be withheld unless the subcontracts are found to contain provisions manifestly contrary to the public interest (e.g. excessive payments to subcontractors or unreasonable limitations of liability) or contrary to mandatory rules having the nature of public law that apply to the execution of privately financed infrastructure projects in the host country.

C. Construction projects

5. Domestic laws and regulations on traditional contracts for public works often contain extensive provisions on the execution of the work and the procedures to ensure compliance by the contractors with the design and other project specifications. Contracting authorities purchasing construction work typically act as the employer under a construction contract and retain extensive monitoring and inspection rights, including the right to review the construction project and request modifications thereof, to follow closely the construction work and schedule, to inspect and formally accept the completed work and to give final authorization for the operation of the facility.

6. In contrast, in many privately financed infrastructure projects, the contracting authority may envisage a different allocation of responsibilities between the public and the private sector. Instead of assuming the direct responsibility for managing the details of the project, contracting authorities in those countries may prefer to transfer such responsibility to the concessionaire by requiring the concessionaire to assume full responsibility for the timely completion of the construction. The concessionaire, too, will be interested in ensuring that the project is completed on time and that the cost estimate is not exceeded and will typically negotiate fixed-price, fixed-time turnkey contracts including guarantees of performance by the construction contractors. Therefore, in privately financed infrastructure projects it is the concessionaire that for most purposes performs the role of the employer under the construction contracts.

7. It flows from the above that laws and regulations governing traditional contracts for public works may not be entirely suitable for privately financed infrastructure projects. For that reason, legislative provisions on the construction of privately financed infrastructure facilities are in some countries limited to a general definition of the concessionaire's obligation to perform the public works in accordance with the provisions of the project agreement and give the contracting authority the general right to monitor the progress of the work with a view to ensuring that it conforms to the provisions of the agreement. In those countries, more detailed provisions are then left to the project agreement.

1. Review and approval of construction plans

8. Where it is felt necessary to deal with construction projects and related matters in legislation, it is advisable to devise procedures that help to keep completion time and construction costs within estimates and lower the potential for disputes between the concessionaire and the public authorities involved. For instance, where statutory provisions require that the contracting authority review and approve the construction project, the project agreement should establish a deadline for the review of the construction project and provide that the approval shall be deemed to be granted if no objections are made by the contracting authority within the relevant period. It may also be useful to set out in the project agreement the grounds on which the contracting authority may raise objections to or request modifications in the project (e.g. safety, defence, security, environmental concerns or non-conformity with the specifications).

9. It should be noted that, in some legal systems, the party exercising ultimate control over the design or specification of a construction project may bear a certain degree of liability for defects arising from the inadequacy of the approved design or specifications. Therefore, it may be advisable for the project agreement to clarify that the contracting authority does not bear any liability in that regard, except where the design and specifications were originally provided by the contracting authority itself (see also chap. III, "Selection of the concessionaire", ___).

2. Variation in the project terms

10. During the course of the construction of an infrastructure facility, it is common for situations to be encountered that make it necessary or advisable to vary certain aspects of the construction. The contracting authority may therefore wish to retain the right to order changes in respect of such aspects as the scope of construction, the technical characteristics of equipment or materials to be incorporated in the work or the construction services required under the specifications. Such changes are referred to in the *Guide* as "variations". As used in the *Guide*, the word "variation" does not include adjustments or revision of tariffs and prices because of cost changes or currency fluctuations (see paras. 32-37). Likewise, renegotiation of the project agreement in cases of substantial change in conditions (see paras. 59-68) is not regarded in the *Guide* as a variation.

11. Given the complexity of most infrastructure projects, it is not possible to exclude the need for variations in the construction specifications or other requirements of the project. However such variations often cause delay in the execution of the project or in the delivery of the public service; they may also render the performance under the project agreement more onerous for the concessionaire. Furthermore, the cost of implementing extensive variation orders may exceed the concessionaire's own financial means, thus requiring substantial additional funding that may not be obtainable at an acceptable cost. Therefore, it is advisable for the contracting authority to consider measures to control the possible need for variations. The quality of the feasibility studies conducted by the contracting authority and of the specifications provided during the selection process (see chap. III, "Selection of the concessionaire", ___) play an important role in avoiding subsequent changes in the project.

12. The concessionaire will require assurances that it will not incur additional cost or liability for delay resulting from variations sought by the contracting authority. Thus, it is advisable to require that the project agreement set forth the specific circumstances under which the contracting authority may order variations in respect of construction terms and the compensation that may be due to the concessionaire, as appropriate, to cover the additional cost entailed by the variations. The project agreement should also clarify the extent to which the concessionaire is obliged to implement those variations and whether the concessionaire may object to variations and, if so, on which grounds. Furthermore, following a contractual practice common in some legal systems, it may be advisable to provide in the project agreement that the concessionaire is released of its obligations when the amount of additional costs entailed by the modification exceeds a set maximum limit.

13. Various contractual approaches for dealing with variations have been used in large construction contracts to deal with the extent of the contractor's obligation to implement changes and the required adjustments in the contract price or contract duration.[1] Such solutions may also be used, *mutatis mutandis*, to deal with variations sought by the contracting authority under the project agreement. It should be noted, however, that, in infrastructure concessions, the project company's payment consists in user fees or prices for the output of the facility, rather than a global price for the construction work. Thus, compensation methods used in connection with infrastructure concessions sometimes include a combination of various methods ranging from lump-sum payments to tariff increases, or extensions of the concession period. For instance, there may be changes that result in an increase in the cost that the concessionaire might be able to absorb or finance itself and amortize by means of an adjustment in the tariffs or payment mechanism, as appropriate. If the concessionaire cannot refinance or fund the changes itself, the parties may wish to consider lump-sum payments as an alternative to an expensive and complicated refinancing structure.

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[1] For a discussion of approaches and possible solutions used in construction contracts for complex industrial works, see *UNCITRAL Legal Guide on Drawing Up Contracts for the Construction of Industrial Works* (United Nation publication, Sales No. E.87.V.10), chapter XXIII, "Variation clauses".

3. Monitoring powers of the contracting authority

14. In some legal systems, governmental agencies purchasing construction projects customarily retain the power to order the suspension or interruption of the projects for reasons of public interest. However, with a view to providing some comfort to potential investors, it may be useful to limit the possibility of such interference only to extraordinary circumstances and to provide that no such interruption should be of a duration or extent greater than is necessary, taking into consideration circumstances that gave rise to the requirement to suspend or interrupt the work. It may also be useful to agree on a maximum period of suspension and to provide for compensation to the concessionaire for any suspension in excess of the agreed maximum period. Furthermore, guarantees may be provided to ensure payment of compensation or to indemnify the concessionaire for loss resulting from suspension of the project (see also chap. II, "Project risks and Government support", ___).

15. Provisions concerning final inspection and approval of the construction work by the contracting authority may be of particular importance in connection with health, safety, building or labour regulations. They may also be of importance in respect of facilities that are the subject of regulatory control (for safety or similar reasons) or where the Government would have a direct or residual liability to the public for damage or injury attributable to defects in the construction of the facility.

16. The project agreement should set out in detail the nature of the completion tests or the inspection of the completed facility; the timetable for the tests (for instance, it might be appropriate to undertake partial tests over a period, rather than a single test at the end); the consequences of failure to pass a test; and the responsibility for organizing the resources for the test and covering the corresponding costs. Final approval of the work by the contracting authority is usually a condition for authorizing that the facility should be brought into operation. In some countries, it was found useful to authorize the facility to operate on a provisional basis, pending final acceptance by the contracting authority, and to provide an opportunity for the concessionaire to rectify defects that might be found at that juncture. Where regulatory or liability issues are not an immediate concern for the contracting authority, the contracting authority may satisfy itself with requiring the concessionaire to undertake those tests and to provide appropriate guarantees that the facility is fit for being put into operation.

17. For projects requiring that the facility and related assets be handed over to the contracting authority at the end of the concession period (see chap. VI, "End of project term, extension and termination", ___), such as in "build-operate-transfer" (BOT) and similar types of projects, or where the operation is handed over to the contracting authority immediately upon completion of the construction work, it is important to lay down in the project agreement the requirements to assure the long-term durability of the facility being constructed beyond the concession period. Also, the contracting authority should have assurances that it will receive all that is necessary in order to carry out the long-term operation of the facility, such as drawings, maintenance records kept during its operation by the concessionaire and any manuals that have been developed for operation and maintenance. It is also important to make provisions for adequate training of the contracting authority's personnel prior to the ultimate handing over of the facility.

D. Infrastructure operation

18. During the operational phase the concessionaire undertakes to operate and maintain the infrastructure facility and to collect revenue from the users. Conditions for the operation and maintenance of the facility, as well as for quality and safety standards, are often recited in the law and spelled out in detail in the project agreement. In countries that have general legislation on concessions, the law might, for example, limit itself to a general description of the main obligations of public service providers and refer the matter to the project agreement. Where specific legislation is required in order for the contracting authority to carry out certain types of projects, the relevant statute often sets forth the conditions for the operation and maintenance of the relevant infrastructure facilities and is supplemented by more detailed provisions in regulations governing that particular

infrastructure sector and in the project agreement, an approach that is common to various legal systems. In addition, particularly in the fields of electricity, water and sanitation and public transportation, the contracting authority or an independent regulatory body may exercise an oversight function over the operation of the facility. An exhaustive discussion of legal issues relating to the conditions of operation of infrastructure facilities would exceed the scope of the *Guide*. Therefore, the following paragraphs contain only a brief presentation of some of the main issues.

19. Regulatory provisions on infrastructure operation and legal requirements for the provision of public services are intended to achieve various objectives of public relevance. Given the usually long duration of infrastructure projects, there is a possibility that such provisions and requirements may need to be changed during the life of the project agreement. It is important, however, to bear in mind the private sector's need for a stable and predictable regulatory framework. Changes in regulations or the frequent introduction of new and more stringent rules may have a disruptive impact on the implementation of the project and compromise its financial viability. Therefore, while contractual arrangements may be agreed to by the parties to counter the adverse effects of subsequent regulatory changes (see paras. 60-63), regulatory bodies would be well advised to avoid excessive regulation or unreasonably frequent changes in existing rules.

1. General duties of public service providers

20. In various legal systems, entities providing public services have certain special obligations to their users or customers or to other public service providers. The most common such obligations are discussed below.

(a) Extension of services

21. In some legal systems, an entity operating under a governmental concession to provide certain essential services (e.g. electricity or potable water) to a community or territory and its inhabitants is held to assume an obligation to provide a service system that is reasonably adequate to meet the demand of the community or territory. That obligation often relates not only to the historic demand at the time the concession was awarded, but implies an obligation to keep pace with the growth of the community or territory served and gradually to extend the system as may be required by the reasonable demand of the community or territory. In some legal systems, the obligation has the nature of a public duty that may be invoked by any resident of the relevant community or territory. In other legal systems, it has the nature of a statutory or contractual obligation that may be enforced by the contracting authority or by a regulatory body, as the case may be.

22. The obligation, where it exists, is not absolute and unqualified. The concessionaire's duty to extend its service facilities depends, in some legal systems, upon various factors, such as the need and cost of the extension and the revenue that may be expected as a result of the extension; the concessionaire's financial condition; the public interest in effecting such an extension; and the scope of the obligations assumed by the concessionaire in that regard under the project agreement. In some legal systems, the concessionaire may be under an obligation to extend its service facilities even if the particular extension is not immediately profitable or even if, as a result of the extensions being carried out, the concessionaire's territory might eventually include unprofitable areas. That obligation is nevertheless subject to some limits, since the concessionaire is not required to carry out extensions that place an unreasonable burden on the concessionaire or its customers. Depending on the particular circumstances, the cost of carrying out extensions of service facilities may be absorbed by the concessionaire, passed on to the customers or end users in the form of price increases or extraordinary charges, or it may be absorbed in whole or in part by the contracting authority or other governmental agency by means of subsidies or grants. Given the variety of factors that may need to be taken into account in order to assess the reasonableness of any particular extension, it is advisable to require that the project agreement set forth the circumstances under which the concessionaire may be required to carry out extensions in its service facilities and the appropriate methods for financing the cost of any such extension.

(b) Continuity of service

23. Another obligation of public service providers is to ensure the continuous provision of the service under most circumstances, except for narrowly defined exempting events (see also paras. 70-73). In some legal systems, the obligation has the nature of a statutory duty that applies even if it is not expressly recited in the project agreement. The corollary of that rule, in legal systems where it exists, is that various circumstances that under general principles of contract law might authorize a contract party to suspend or discontinue the performance of its obligations (e.g. economic hardship or breach by the other party) cannot be invoked by the concessionaire as grounds for suspending or discontinuing, in whole or in part, the provision of a public service. In some legal systems, the contracting authority may even have special enforcement powers to compel the concessionaire to resume providing service in the event of unlawful discontinuance.

24. That obligation, too, is subject to a general rule of reasonableness. Various legal systems recognize the concessionaire's right to fair compensation for having to deliver the service under situations of hardship (see paras. 74-79). Moreover, in some legal systems, it is held that a public services provider may not be required to operate where its overall operation results in a loss. Where the public service as a whole, and not only one or more of its branches or territories, ceases being profitable, the concessionaire may have the right to a direct compensation by the contracting authority or, alternatively, the right to terminate the project agreement. However, termination typically requires the consent of the contracting authority or a judicial decision. It is therefore advisable to clarify in the project agreement which extraordinary circumstances would justify the suspension of the service or even release the concessionaire from its obligations under the project agreement (see also chap. VI, "End of project term, extension and termination", ___).

(c) Equal treatment of customers or users

25. Entities that provide certain services to the general public are, in some jurisdictions, under an obligation to ensure the availability of the service under essentially the same conditions to all users and customers falling within the same category. However, any differentiation based on a reasonable and objective classification of customers and users is accepted in those legal systems as long as like contemporaneous service is rendered to consumers and users engaged in like operations under like circumstances. Therefore, it may not be inconsistent with the principle of equal treatment to charge different prices or to offer different access conditions to different categories of users (e.g. domestic consumers, on the one hand, and business or industrial consumers, on the other), provided that the differentiation is based on objective criteria and corresponds to actual differences in the situation of the consumers or the conditions under which the service is provided to them. Nevertheless, where a difference in charges or other conditions of service is based on actual differences in service (e.g. higher charges for services provided at hours of peak consumption), it typically has to be commensurate with the amount of difference.

26. In addition to differentiation established by the concessionaire itself, different treatment of certain users or customers may be the result of legislative action. In many countries, the law requires that specific services must be provided at particularly favourable terms to certain categories of users and customers (e.g. discounted transport for schoolchildren or senior citizens or reduced water or electricity rates for lower-income or rural users). Public service providers may recoup these service burdens or costs in several ways, including through Government subsidies, through funds or other official mechanisms created to share the financial burden of these obligations among all public service providers, or through internal cross-subsidies from other profitable services (see chap. II, "Project risks and Government support", ___).

(d) Interconnection and access to infrastructure networks

27. Companies operating infrastructure networks in sectors such as railway transport, telecommunications or power or gas supply are sometimes required to allow other companies to have access to the network. The requirement may be set forth in the project agreement or may be stated in sector-specific laws or regulations. Interconnection and access requirements have been introduced in certain infrastructure sectors as a complement to vertical unbundling measures; in others, they have been adopted to foster competition in sectors that remained fully or partially integrated (for a brief discussion of market structure issues, see above, "Introduction and background information", ___).

28. Network operators are often required to provide access on terms that are fair and non-discriminatory from a financial as well as a technical point of view. Non-discrimination implies that the new entrant or service provider should be able to use the infrastructure of the network operator on conditions that are not less favourable than those granted by the network operator to its own services or to those of competing providers. It should be noted, however, that many pipeline access regimes, for example, do not require completely equal terms for the carrier and rival users. The access obligation may be qualified in some way. It may, for instance, be limited to spare capacity only or be subject to reasonable, rather than equal, terms and conditions.

29. While access pricing is usually cost-based, regulatory bodies will wish to retain the right to monitor access prices to ensure that they are high enough to give adequate incentive to invest in the required infrastructure and low enough to allow new entrants to compete at fair terms. Where the network operator provides services in competition with other providers, there may be requirements that its activities be separated from an accounting point of view in order to determine the actual cost of the use by third parties of the network or parts thereof.

30. Technical access conditions may be equally important, and network operators may be required to adapt their network to satisfy the access requirements of new entrants. Access may be to the network as a whole or to monopolistic parts or segments of the network (sometimes also referred to as bottleneck or essential facilities). Many Governments allow service providers to build their own infrastructure or to use alternative infrastructure where available. In such cases, the service provider may only need access to a small part of the network and cannot, under many regulations, be forced to pay more than the cost corresponding to the use of the specific facility it needs, such as the local telecommunications loop, transmission capacity for the supply of electricity or the use of a track section of railway.

2. Price control

31. Except where the concessionaire is free to determine its tariff and commercial policy, domestic laws often subject the prices charged by the concessionaire to some control mechanism. Many countries have chosen to set only the broad pricing principles in legislation while leaving their actual implementation to the regulatory body concerned and to the terms and conditions of licences or concessions. Where price control measures are used, the law typically requires that the formula must be advertised with the request for proposals and must be incorporated in the project agreement. Price control systems typically consist of formulas for the adjustment of prices and monitoring provisions to ensure compliance with the parameters for price adjustment.

(a) Price control methods

32. The most common price control methods used in domestic laws are rate-of-return and price-cap methods. There are also hybrid regimes that have elements of both. These methods are briefly discussed below.

(i) Rate-of-return method

33. Under the rate-of-return method, the price adjustment mechanism is devised so as to allow the concessionaire a given return on its investment, usually expressed in percentage terms and representing a weighted average of the cost of debt and the cost of equity. The tariffs for any given period are established on the basis of the concessionaire's overall revenue requirement to operate the facility, which involves determining its expenses, the investments undertaken to provide the services and the allowed rate of return. Reviews of the tariffs are undertaken periodically, sometimes whenever the contracting authority or other interested parties consider that the actual revenue is higher or lower than the revenue requirement of the facility. For that purpose, the contracting authority verifies the expenses of the facility, determines to what extent investments undertaken by the concessionaire are eligible for inclusion in the rate base, and calculates the revenues that need to be generated to cover the allowable expenses and the agreed-upon return on investment.

34. The implementation of the rate-of-return method requires a substantial amount of information, as well as extensive negotiations (e.g. on eligible expenditures and cost allocation). The rate-of-return method has been found to provide a high degree of security for infrastructure operators, since the concessionaire is assured that the tariffs charged will be sufficient to cover its operating expenses and allow the agreed rate of return. Because prices are adjusted regularly, thus keeping the concessionaire's rate of return essentially constant, investment in companies providing public services is exposed to little market risk. The result is typically lower costs of capital. The possible disadvantage of the rate-of-return method is that it provides little incentive for infrastructure operators to minimize their costs because of the assurance that those costs will be recovered through tariff adjustments. However, some level of incentive may exist if the tariffs are not adjusted instantaneously or if the adjustment does not apply retroactively.

(ii) Price-cap method

35. Under the price-cap method, a price formula is set for a given period (e.g. four or five years) taking into account future inflation and future efficiency gains expected from the facility. Prices are allowed to fluctuate within the limits set by the formula. In some countries, the formula is a weighted average of various indices, in others it is a consumer price index minus a productivity factor. Where substantial new investments are required, the formula may include an additional component to cover these extra costs. The formula can apply to all services of the company or to selected groups of services only, and different formulas may be used for different groups. The periodic readjustment of the formula is, however, based on the rate-of-return type of calculations, requiring the same type of detailed information as indicated above, though on a less frequent basis.

36. The implementation of the price-cap method may be less complex than the rate-of-return method. The price-cap method has been found to provide greater incentives for public service providers, since the concessionaire retains the benefits of lower than expected costs until the next adjustment period. At the same time, however, public service providers are typically exposed to more risk under the price-cap method than under the rate-of-return method. In particular, the concessionaire faces the risk of loss when the costs turn out to be higher than expected, since the concessionaire cannot raise the prices until the next price adjustment. The greater risk exposure increases the costs of capital. If the project company's returns are not allowed to rise, there might be difficulties in attracting new investment. Also, the company might be tempted to lower the quality of the service in order to reduce costs.

(iii) Hybrid methods

37. Many tariff adjustment methods being currently used combine elements of both the rate-of-return and the price-cap methods with a view to both reducing the risk borne by the service providers and providing sufficient incentives for efficiency in the operation of the infrastructure. One such hybrid method employs sliding scales

for adjusting the tariffs that ensure upward adjustment when the rate of return falls below a certain threshold and downward adjustment when the rate of return exceeds a certain maximum, with no adjustment for rates of return falling between those levels. Other possible methods include a review by the contracting authority of the investments made by the concessionaire to ensure that they meet the criteria of usefulness in order to be taken into account when calculating the concessionaire's revenue requirement. Another price adjustment technique that may be used to set prices, or more generally to monitor price levels, is benchmark or yardstick pricing. By comparing the various cost components of one public service provider with those of another and with international norms, the contracting authority may be able to judge whether tariff adjustments requested by the public service provider are reasonable.

(b) Policy considerations

38. Each of the main tariff adjustment methods discussed above has its own advantages and disadvantages that have to be taken into account by the legislature when considering the appropriateness of price control methods for the domestic circumstances. Different methods may also be used for different infrastructure sectors. Some laws indeed authorize the contracting authority to apply either a fixed-price or rate-of-return method in the selection of concessionaires, according to the scope and nature of investments and services. Whatever mechanism is chosen, it is important to consider carefully the capacity of the contracting authority to monitor adequately the performance of the concessionaire and to implement satisfactorily the adjustment method (see also chap. I, "General legislative considerations", ___).

39. It is important to bear in mind that price adjustment formulas cannot be set once and for all, as technology, exchange rates, wage levels, productivity and other factors are bound to change significantly, sometimes even unpredictably, over such periods. Therefore, many countries have established mechanisms for revision of tariff formulas, including periodic revisions (e.g. every four or five years) of the formula or ad hoc revisions whenever it is demonstrated that the formula has failed to ensure an adequate compensation to the concessionaire (see also paras. 59-68). The tariff regime will also require adequate stability and predictability to enable public service providers and users to plan accordingly and to allow financing based on a predictable revenue. Investors and lenders may be particularly concerned about regulatory changes affecting the price adjustment method. Thus, they typically require that the price adjustment formula be incorporated in the project agreement.

3. Disclosure requirements

40. Many domestic laws impose on public service providers an obligation to provide to the regulatory body accurate and timely information on their operations, and grant regulatory bodies specific enforcement rights. They may encompass inquiries and audits, including detailed performance and compliance audits, sanctions for non-cooperative companies, and injunctions or penalty procedures to enforce disclosure.

41. Public service providers are normally required to maintain and disclose to the regulatory body their financial accounts and statements and to maintain detailed cost accounting allowing the regulatory body to track various aspects of the company's activities separately. Financial transactions between the concessionaire company and affiliated companies may also require scrutiny, as concessionaire companies may try to transfer profits to non-regulated businesses or foreign affiliates. Infrastructure operators may also have detailed technical and performance reporting requirements. As a general rule, however, it is important to define reasonable limits to the extent and type of information that infrastructure operators are required to submit. Furthermore, appropriate measures should be taken to protect the confidentiality of any proprietary information that the concessionaire and its affiliated companies may submit to the regulatory body.

4. Performance standards

42. Public service providers generally have to meet a set of technical and service standards. Such standards are in most cases too detailed to figure in legislation and may be included in implementing decrees, regulations or other instruments. Service standards are often spelt out in great detail in the project agreement. They include quality standards, such as requirements with respect to water purity and pressure; ceilings on time to perform repairs; ceilings on the number of defects or complaints; timely performance of transport services; continuity in supply; and health, safety and environmental standards. Legislation may, however, impose the basic principles that will guide the drafting of detailed standards or require compliance with international standards.

43. The contracting authority typically retains the power to monitor the adherence of the project company to the regulatory performance standards. The concessionaire will be interested in avoiding as much as possible any interruption in the operation of the facility and protecting itself against the consequences of any such interruption. It will seek assurances that the exercise by the contracting authority of its monitoring or regulatory powers does not cause undue disturbance or interruption in the operation of the facility, and that it does not result in undue additional costs to the concessionaire.

5. Enforcement powers of the concessionaire

44. Governmental agencies are typically entrusted with powers designed to facilitate the provision of the service and to ensure that the users comply with the pertinent regulations and rules. Such powers may include, for instance, the right to issue, or control compliance with, safety rules and the right to suspend the provision of service for emergency or safety reasons. Those powers typically derive from the overall authority of the Government, and in some legal systems, they are inherently governmental.

45. In countries with a well-established tradition of awarding concessions for the provision of public services, the concessionaire may be entrusted with the necessary powers by a delegation of authority from the Government. The extent of powers delegated to the concessionaire is usually defined in the project agreement and may not need to be provided in detail in legislation. Nevertheless, it may be useful for the law to provide that the concessionaire may be authorized to issue rules governing the use of the facility by the public and to take reasonable measures to ensure compliance by the public with those rules. It may be advisable to provide that they should become effective upon approval by the regulatory body or the contracting authority, as appropriate. However, the right to approve operating rules proposed by the concessionaire should not be discretionary and the concessionaire should have the right to appeal a decision to refuse approval of the proposed rules (see chap. I, "General legislative considerations", ___).

46. Of particular importance for the concessionaire is the question whether the provision of the service may be discontinued because of default or non-compliance by its users. Despite the concessionaire's general obligation to ensure the continuous provision of the service (see paras. 23-24), many legal systems recognize that entities providing public services may issue and enforce rules that provide for shutting off of the service for a consumer or user who has defaulted in payment for it or who has seriously infringed the conditions for using it. The power to do so is often regarded as crucial in order to prevent abuse and ensure the economic viability of the service. However, given the essential nature of certain public services, that power may require legislative authority in some legal systems. Furthermore, there may be a number of expressed or implied limitations or conditions for the exercise of that power, such as special notice requirements and specific consumer remedies. Additional limitations and conditions may derive from the application of general consumer protection rules (see chap. VII, "Governing law", ___).

F. Performance guarantees and insurance

47. The obligations of the concessionaire are usually complemented by the provision of some form of guarantee of performance in the event of default and insurance coverage against a number of risks. The law in some countries generally requires that adequate guarantees of performance be provided by the concessionaire and refer the matter to the project agreement for further details. In other countries, the law contains more detailed provisions, for instance requiring the provision of a certain type of guarantee up to a certain percentage of the basic investment.

1. Types, functions and the nature of performance guarantees

48. Performance guarantees are generally of two types. Under one type, the monetary performance guarantee, the guarantor undertakes only to pay the contracting authority funds up to a stated limit to satisfy the liabilities of the concessionaire in the event of the latter's failure to perform. Monetary performance guarantees may take the form of a contract bond, a stand-by letter of credit or an on-demand guarantee. Under the other type of guarantee, the performance bond, the guarantor chooses one of two options: (a) to rectify defective or finish incomplete construction itself; or (b) to obtain another contractor to rectify defective or finish incomplete construction and compensate the contracting authority for losses caused by the failure to perform. The value of such an undertaking is limited to a stated amount or a certain percentage of the contract value. Under a performance bond, the guarantor also frequently reserves the option to discharge its obligations solely by the payment of money to the contracting authority. Performance bonds are generally furnished by specialized guarantee institutions, such as bonding and insurance companies. A special type of performance bond is the maintenance bond, which protects the contracting authority against future failures that could arise during the start-up or maintenance period and serve as guarantee that any repair or maintenance work during the post-completion warranty period will be duly carried out by the concessionaire.

49. As regards their nature, performance guarantees may be generally divided into independent guarantees and accessory guarantees. A guarantee is said to be "independent" if the guarantor's obligation is independent from the concessionaire's obligations under the project agreement. Under an independent guarantee (often called a first-demand guarantee) or a stand-by letter of credit, the guarantor or issuer is obligated to make payment on demand by the beneficiary, and the latter is entitled to recover under the instrument if it presents the document or documents stipulated in the terms of the guarantee or stand-by letter of credit. Such a document might be simply a statement by the beneficiary that the contractor has failed to perform. The guarantor or issuer is not entitled to withhold payment on the ground that there has in fact been no failure to perform under the main contract; however, under the law applicable to the instrument, payment may in very exceptional and narrowly defined circumstances be refused or restrained (e.g. when the claim by the beneficiary is manifestly fraudulent). In contrast, a guarantee is accessory when the obligation of the guarantor involves more than the mere examination of a documentary demand for payment in that the guarantor may have to evaluate evidence of liability of the contractor for failure to perform under the work contract. The nature of the link may vary under different guarantees, and may include the need to prove the contractor's liability in arbitral proceedings. By their nature, performance bonds have an accessory character to the underlying contract.

2. Advantages and disadvantages of various types of performance guarantee

50. From the perspective of the contracting authority, monetary performance guarantees may be particularly useful in covering additional costs that may be incurred by the contracting authority as a result of delay or default by the concessionaire. Monetary performance guarantees may also serve as an instrument to put pressure on the concessionaire to complete construction in time and to perform its other obligations in accordance with the requirements of the project agreement. However, the amount of those guarantees is typically only a fraction

of the economic value of the obligation guaranteed and is usually not sufficient to cover the cost of engaging a third party to perform instead of the concessionaire or its contractors.

51. From the perspective of the contracting authority, a first-demand guarantee has the advantage of assuring prompt recovery of funds under the guarantee, without evidence of failure to perform by the contractor or of the extent of the beneficiary's loss. Furthermore, guarantors furnishing monetary performance guarantees, in particular banks, prefer first-demand guarantees, as the conditions are clear as to when their liability to pay accrues, and the guarantors will thus not be involved in disputes between the contracting authority and the concessionaire as to whether or not there has been a failure to perform under the project agreement. Another advantage for a bank issuing a first-demand guarantee is the possibility of quick and efficient recovery of the sums paid under a first-demand guarantee by direct access to the concessionaire's assets.

52. A disadvantage to the contracting authority of a first-demand guarantee or a stand-by letter of credit is that those instruments may increase the overall project costs, since the concessionaire is usually obliged to obtain and set aside large counter-guarantees in favour of the institutions issuing the first-demand guarantee or the stand-by letter of credit. Also, a concessionaire that furnishes such a guarantee may wish to take out insurance against the risk of recovery by the contracting authority under the guarantee or the stand-by letter of credit when there has been in fact no failure to perform by the concessionaire, and the cost of that insurance is included in the project cost. The concessionaire also may include in the project cost the potential costs of any action that it may need to institute against the contracting authority to obtain the repayment of the sum improperly claimed. In addition, to the extent the contracting authority can obtain the sum payable under the guarantee or the stand-by letter of credit upon its bare statement that the concessionaire has failed to perform, the concessionaire may wish to fix the sum payable at a small percentage of the project cost, and thereby limit the loss it may suffer from having to reimburse the guarantor in the event of a claim by the contracting authority when there has been no failure to perform.

53. A disadvantage to the concessionaire of a first-demand guarantee or a stand-by letter of credit is that, if there is recovery by the contracting authority when there has been no failure to perform by the concessionaire, the latter may suffer immediate loss if the guarantor or the issuer of the letter of credit reimburses itself from the assets of the concessionaire after payment to the contracting authority. The concessionaire may also experience difficulties and delays in recovering from the contracting authority the sum improperly claimed.

54. The terms of an accessory guarantee usually require the beneficiary to prove the failure of the contractor to perform and the extent of the loss suffered by the beneficiary. Furthermore, the defences available to the debtor if it is sued for a failure to perform are also available to the guarantor. Accordingly, there is a possibility that the contracting authority will face a protracted dispute when it makes a claim under the bond. However, as a reflection of the lesser risk borne by the guarantor, which also reflects the lower cost of an accessory guarantee, the monetary limit of liability of the guarantor may be considerably higher than under a first-demand guarantee, thus covering a larger percentage of work under the project agreement. A performance bond may also be advantageous if the contracting authority cannot conveniently arrange for the rectification of faults or completion of construction itself and requires the assistance of a third party to arrange for rectification or completion. Where, however, the construction involves the use of a technology known only to the concessionaire, rectification or completion by a third person may not be feasible, and a performance bond may not have the last-mentioned advantage over a monetary performance guarantee. For the concessionaire, accessory guarantees have the advantage of preserving the concessionaire's borrowing power, since accessory guarantees, unlike first-demand guarantees and stand-by letters of credit, do not affect the concessionaire's line of credit with the lenders.

55. It flows from the above considerations that different types of guarantees may be useful in connection with the various obligations assumed by the concessionaire. While it is useful to require the concessionaire to provide

adequate guarantees of performance, it is advisable to leave it to the parties to determine the extent to which guarantees are needed and which guarantees should be provided in respect of the various obligations assumed by the concessionaire, rather than requiring in the law only one form of guarantee to the exclusion of others. It should be noted that the project company itself will require a series of performance guarantees to be provided by its contractors (see para. 6) and that additional guarantees to the benefit of the contracting authority usually increase the overall cost and complexity of a project. In some countries, practical guidance provided to domestic contracting authorities advises them to consider carefully whether and under what circumstances such guarantees are required, which specific risks or loss they should cover and which type of guarantee is best suited in each case. The ability of the project company to raise finance for the project may be jeopardized by bond requirements set at an excessive level.

56. One particular problem of privately financed infrastructure projects concerns the duration of the guarantee. The contracting authority may have an interest in obtaining guarantees of performance that remain valid during the entire life of the project, covering both the construction and the operational phase. However, given the long duration of infrastructure projects and the difficulty in evaluating the various risks that may arise, it may be problematic for the guarantor to issue a performance bond for the whole duration of the project or to procure reinsurance for its obligations under the performance bond. In practice, this problem is compounded by stipulations that the non-renewal of a performance bond constitutes a reason for a call on the bond, so that merely allowing the project company to provide bonds for shorter periods may not be a satisfactory solution. One possible solution, used in some countries, is to require separate bonds for the construction and the operation phase, thus allowing for better assessment of risks and reinsurance prospects. Such a system may be enhanced by defining in precise terms the risk to be covered during the operational period, thus allowing for a better assessment of risks and a reduction of the total amount of the bond. Another possibility to be considered by the contracting authority may be to require the provision of performance guarantees during specific crucial periods, rather than for the entire duration of the project. For instance, a bond might be required during the construction phase and last for an appropriate period beyond completion, so as to cover possible late defects. Such a bond might then be replaced by a performance bond for a certain number of years of operation, as appropriate in order for the project company to demonstrate its capability to operate the facility in accordance with the required standards. If the project company's performance proves to be satisfactory, the bond requirement might be waived for the remainder of the operation phase, up to a certain period before the end of the concession term, when the project company might be required to place another bond to guarantee its obligations in connection with the handing over of assets and other measures for the orderly wind-up of the project, as appropriate (see chap. VI, "End of project term, extension and termination", ___).

3. Insurance arrangements

57. Insurance arrangements made in connection with privately financed infrastructure projects typically vary according to the phase to which they apply, with certain types of insurance only being purchased during a particular project phase. Some forms of insurance, such as business interruption insurance, may be purchased by the concessionaire in its own interest, while other forms of insurance may be a requirement under the laws of the host country. Forms of insurance often required by law include insurance coverage against damage to the facility, third-party liability insurance, workers' compensation insurance and pollution and environmental damage insurance.

58. Mandatory insurance policies under the laws of the host country often need to be obtained from a local insurance company or from another institution admitted to operate in the country, which in some cases may pose a number of practical difficulties. In some countries, the type of coverage usually offered may be more limited than the standard coverage available on the international market, in which case the concessionaire may remain exposed to a number of perils that may exceed its self-insurance capacity. That risk is particularly serious in connection with environmental damage insurance. Further difficulties may arise in some countries as a result

of limitations on the ability of local insurers to reinsure the risks on the international insurance and reinsurance markets. As a consequence, the project company may often need to procure additional insurance outside the country, thus adding to the overall cost of financing the project.

F. Changes in conditions

59. Privately financed infrastructure projects normally last for a long period of time, during which many circumstances relevant to the project may change. The impact of many changes may be automatically covered in the project agreement, either through financial arrangements such as a tariff structure that includes an indexation clause (see paras. 33-37), or by the assumption by either party, expressly or by exclusion, of certain risks (for example, if the price of fuel or electricity supply is not taken into account in the indexation mechanisms, then the risk of higher than expected prices is absorbed by the concessionaire). However, there are changes that might not lend themselves easily to inclusion in an automatic adjustment mechanism or that the parties may prefer to exclude from such a mechanism. From a legislative perspective, two particular categories deserve special attention: legislative or regulatory changes and unexpected changes in economic conditions.

1. Legislative and regulatory changes

60. Given the long duration of privately financed infrastructure projects, the concessionaire may face additional costs in meeting its obligations under the project agreement because of future, unforeseen changes in legislation applying to its activities. In extreme cases, legislation could even make it financially or physically impossible for the concessionaire to carry on with the project. For the purpose of considering the appropriate solution for dealing with legislative changes, it may be useful to distinguish between legislative changes having a particular incidence on privately financed infrastructure projects or on one specific project, on the one hand, and general legislative changes affecting also other economic activities, and not only infrastructure operation, on the other hand.

61. All business organizations, in the private and public sectors alike, are subject to changes in law and generally have to deal with the consequences that such changes may have for business, including the impact of changes on the price of or demand for their products. Possible examples might include: changes in the structure of capital allowances that apply to entire classes of assets, whether owned by the public or private sector and whether related to infrastructure projects or not; regulations that affect the health and safety of construction workers on all construction projects not just infrastructure projects; and changes in the regulations on the disposal of hazardous substances. General changes in law may be regarded as an ordinary business risk rather than a risk specific to the concessionaire's activities, and it might be difficult for the Government to undertake to protect infrastructure operators from the economic and financial consequences of changes in legislation that affect equally other business organizations. Thus, there may not be a *prima facie* reason why the concessionaire should not bear the consequences of general legislative risks, including the risk of costs arising from changes in law applying to the whole business sector.

62. Nevertheless, it is important to take into account possible limitations in the concessionaire's capacity to respond to or absorb cost increases that result from general legislative changes. Infrastructure operators are often subject to service standards and price control mechanisms (see paras. 31-39) that make it difficult for them to respond to changes of law in the same manner as other private companies (e.g. by increasing tariffs or by reducing services). Where price control mechanisms are provided in the project agreement, the concessionaire will seek to obtain assurances from the contracting authority and the regulatory body, as appropriate, that it will be allowed to recover the additional costs entailed by changes in legislation by means of price increases. Where such an assurance cannot be given, it is advisable to empower the contracting authority to negotiate with the

concessionaire the compensation to which the concessionaire might be entitled in the event that price control measures do not allow for full recovery of the additional costs generated by general legislative changes.

63. A different situation arises when the concessionaire faces increased costs as a result of specific legislative changes that target the particular project, a class of similar projects or privately financed infrastructure projects in general. Such changes cannot be regarded as an ordinary business risk and may significantly alter the economic and financial assumptions under which the project agreement was negotiated. Thus, the contracting authority often agrees to bear the additional cost resulting from specific legislation that targets the particular project, a class of similar projects or privately financed infrastructure projects in general. For example, in highways projects, legislation aimed at a specified road project or road operating company, or at that class of privately operated road projects, might result in a price adjustment under the relevant provisions in the project agreement.

2. Changes in economic conditions

64. Some legal systems have rules that allow a revision of the terms of the project agreement following changes in the economic or financial conditions that, without preventing the performance of a party's contractual obligations, render the performance of those obligations substantially more onerous than originally foreseen at the time they were entered into. In some legal systems, the possibility of a revision of the terms of the agreement is generally implied in all Government contracts, or is expressly provided for in the relevant legislation.

65. The financial and economic considerations for the concessionaire's investment are negotiated in the light of assumptions based on the circumstances prevailing at the time of the negotiations and the reasonable expectations of the parties as to how those circumstances will evolve during the life of the project. Given the long duration of infrastructure projects, the concessionaire will seek to negotiate mechanisms that provide some protection against the adverse financial and economic impact of extraordinary and unforeseen events that could not have been taken into account when the project agreement was negotiated or mechanisms that, had they been taken into account, would have resulted in a different risk allocation or consideration for the concessionaire's investment. As a consequence, revision rules have been applied in a number of countries and have been found useful to help the parties find equitable solutions for ensuring the continued economic and financial viability of infrastructure projects, thus averting a disruptive failure of performance by the concessionaire. However, revision rules may also have some disadvantages, particularly from the perspective of the Government.

66. As with general legislative changes, changes in economic conditions are risks to which most business organizations are exposed without having recourse to a general guarantee of the Government that would protect them against the economic and financial effects of those changes. An unqualified obligation of the contracting authority to compensate the concessionaire for changes of economic conditions may result in a reversion to the public sector of a substantial portion of the commercial risks originally allocated to the concessionaire and represent an open-ended financial liability. Furthermore, it should be noted that the proposed tariff level and the essential elements of risk allocation are important if not decisive factors in the selection of the concessionaire. An excessively generous recourse to renegotiation of the project may lead to unrealistically low proposals being submitted during the selection procedure in the expectation of tariff increases once the project has been awarded. Thus, the contracting authority may have an interest in establishing reasonable limits for statutory or contractual provisions authorizing revisions of the project agreement following changes in economic conditions.

67. It may be desirable to provide in the project agreement that a change in circumstances that justifies a revision of the project agreement must have been beyond the control of the concessionaire and of such a nature that the concessionaire could not reasonably be expected to have taken it into account at the time the project

agreement was negotiated or to have avoided or overcome its consequences. For example, a tollroad operator holding an exclusive concession (see chap. IV, "The project agreement", ___) might not be expected to take into account and assume the risk of traffic shortfalls brought about by the subsequent opening of an alternative toll-free road by an entity other than the contracting authority. However, the concessionaire would normally be expected to take into account the possibility of reasonable labour cost increases over the life of the project. Thus, under normal circumstances, the fact that wages turned out to be higher than expected would not be sufficient reason for revising the project agreement.

68. It may also be desirable to provide in the project agreement that a request for revision of the project agreement requires that the alleged changes of economic and financial conditions amount to a certain minimum value in proportion to the total project cost or the concessionaire's revenue. Such a rule might be useful to avoid cumbersome adjustment negotiations for small changes until the changes have accumulated to comprise a significant figure. In some countries, there are rules that establish a ceiling for the cumulative amount of periodic revisions of the project agreement. The purpose of such rules is to avoid the misuse of the change mechanism as a means for achieving an overall financial balance that bears no relation to the one contemplated in the original project agreement. From the perspective of the concessionaire and the lenders, however, such limitations may represent a considerable risk exposure in the event, for instance, of dramatic cost increases resulting from an extraordinarily severe change of circumstances. Therefore, the desirability of introducing such a ceiling, and the appropriate amount, should be carefully considered.

G. Exemption provisions

69. During the life of an infrastructure project, events may occur that impede the performance by a party of its contractual obligations. The events causing such impediment are typically outside either party's control and may be of a physical nature, such as a natural disaster, or may be the result of human action, such as war, riots or terrorist attacks. Many legal systems generally recognize that a party that fails to perform a contractual obligation because of the occurrence of certain types of events may be exempted from the consequences of such failure to perform.

1. Definition of exempting events

70. Exempting circumstances typically include occurrences beyond the control of a party that cause the party to be unable to perform its obligation and that the party has been unable to overcome by the exercise of due diligence. Common examples include the following: natural disasters (e.g. cyclones, floods, droughts, earthquakes, storms, fires or lightning); war (whether declared or not) or other military activity, including riots and civil disturbance; failure or sabotage of facilities, acts of terrorism, criminal damage or the threat of such acts; radioactive or chemical contamination or ionizing radiation; effects of the natural elements, including geological conditions that cannot be foreseen and resisted; and employees' strikes of exceptional importance.

71. Some laws make only a general reference to exempting circumstances, whereas other laws contain extensive lists of circumstances that excuse the parties from performance under the project agreement. The latter technique may serve the purpose of ensuring a consistent treatment of the matter for all projects developed under the relevant legislation, thus avoiding situations where one concessionaire obtains a more favourable allocation of risks than that provided in other project agreements. However, it is important to consider the possible disadvantages of setting forth in statutory or regulatory provisions a list of events that are to be considered exempting impediments for all cases. There is a risk that the list might be incomplete, leaving out important impediments. Furthermore, certain natural disasters, such as storms, cyclones and floods, may be normal conditions at a particular time of the year at the project site. As such, those natural disasters may represent risks that any public service provider acting in the region would be expected to assume.

72. Another aspect that may need to be carefully considered is whether and to what extent certain acts of governmental agencies other than the contracting authority may constitute exempting impediments. The concessionaire may be required to secure a licence or other official approval for the performance of certain of its obligations. The project agreement might thus provide that, if the licence or approval is refused, or if it is granted but later withdrawn, because of the concessionaire's own failure to meet the relevant criteria for the issuance of the licence or approval, cannot rely on the refusal as an exempting impediment. However, if the licence or approval is refused or withdrawn for extraneous or improper motives, it would be equitable to provide that the concessionaire may rely on the refusal as an exempting impediment. A further possibility of impediment might be an interruption of the project brought about by an organ of the Government other than the contracting authority, for instance, because of changes in governmental plans and policies that require the interruption or major revision of the project that affect substantially the original design. In such situations, it may be important to consider the institutional relationship between the contracting authority and the governmental agency that brings about the impediment as well as their degree of independence from one another. An event classified as an exempting impediment may in some cases amount to an outright breach of the project agreement by the contracting authority depending on whether the contracting authority could reasonably control or influence the acts of the other governmental agency.

73. In the light of the above, it is advisable to identify in the project agreement the circumstances that exempt either party from performance under that agreement, so as to give the parties the necessary freedom to find suitable arrangements. In order to avoid practical controversies, the project agreement should also clarify whether exempting circumstances produce automatic effects or whether their occurrence needs to be established by the parties using a special procedure.

2. Consequences for the parties

74. In some legal systems, the occurrence of an exempting circumstance suspends the execution of the project or the operation of the concession for the duration of the impediment. In other legal systems, the project agreement is not technically suspended, but if the circumstances are such that the concessionaire is rendered unable to comply with its obligations under the project agreement, such inability is not construed as being a breach of the project agreement. The main issues to be considered in connection with the occurrence of any exempting event are whether additional time is granted for the performance of the obligation, and which party bears the cost entailed by the delay or the cost of repairing damaged property.

75. During the construction phase, the occurrence of exempting circumstances usually justifies an extension of the time allowed for the completion of the facility. In that connection, it is important to consider the implications of any such extension for the overall duration of the project, particularly where the construction phase is taken into account for calculating the total concession period. Delays in the completion of the facility reduce the operational period and may adversely affect the global revenue estimates of the concessionaire and the lenders. It may therefore be advisable to consider under what circumstances it may be justified to extend the concession period so as to take into account possible extensions that occur during the construction phase. Lastly, it is advisable to provide that, if the event in question is of a permanent nature, the parties may have the option to terminate the project agreement (see also chap. VI, "End of project term, extension and termination", ___).

76. Another important question is whether the concessionaire will be entitled to compensation for revenue loss or property damage that results from the occurrence of exempting circumstances. The answer to that question is given by the risk allocation provided in the project agreement. Except for cases in which the Government provides some form of direct support (see chap. II, "Project risks and government support", ___), privately financed infrastructure projects are typically undertaken at the concessionaire's own risk, including the risk of losses that may result from natural disasters and other exempting circumstances, against which the

concessionaire is usually required to procure adequate insurance coverage (see paras. 57-58). Thus, some laws expressly exclude any form of compensation to the concessionaire in the event of loss or damage that results from the occurrence of exempting circumstances. It does not necessarily follow, however, that an event qualified as an exempting circumstance may not, at the same time, justify a revision of the terms of the project agreement so as to restore its economic and financial balance (see also paras. 59-68).

77. However, a different type of risk allocation is sometimes contemplated for projects involving the construction of facilities that are permanently owned by the contracting authority or facilities that are required to be transferred to the contracting authority at the end of the project period. In some countries, the contracting authority is authorized to make arrangements for assisting the concessionaire to repair or rebuild infrastructure facilities damaged by natural disasters or similar occurrences defined in the project agreement, provided that the possibility of such assistance was contemplated in the request for proposals. Sometimes the contracting authority is authorized to agree to pay compensation to the concessionaire in case of an interruption of the work for more than a certain number of days up to a maximum time limit, if the interruption is caused by an event for which the concessionaire is not responsible.

78. Should the concessionaire become unable to perform because of any such impediment, and should the parties fail to achieve an acceptable revision of the contract, some national laws authorize the concessionaire to terminate the project agreement, without prejudice to the compensation that might be due under the circumstances (see chap. VI, "End of project term, extension and termination", ___).

79. Statutory and contractual provisions on exempting circumstances also need to be considered in the light of other rules governing the provision of the service concerned. The law in some legal systems requires public service providers to make best efforts to continue providing the service despite the occurrence of circumstances defined as contractual impediments (see paras. 23-24). In those cases, it is advisable to consider the extent to which such an obligation may reasonably be imposed on the concessionaire and what compensation may be due for the additional costs and hardship faced by it.

H. Events of default and remedies

80. Generally, there is a wide range of remedies that the parties may agree on to deal with the consequences of default, culminating with termination. The present section discusses general considerations on events of default and remedies by either party (see paras. 81-82). It considers the legislative implication of certain types of remedies intended to rectify the causes of default and preserve the continuity of the project, in particular the intervention of the contracting authority (see paras. 83-86) or the substitution of the concessionaire (see paras. 87-91). The ultimate remedy of terminating the project agreement, and the consequences that result from termination, are discussed elsewhere in the *Guide* (see chap. VI, "End of project term, extension and termination", ___).

1. General considerations on failures to perform and remedies

81. The remedies for default by the concessionaire typically include those that are customary in construction or long-term services contracts such as forfeiture of guarantees, contractual penalties and liquidated damages.[2] In most cases, such remedies are typically contractual in nature and do not give rise to significant legislative considerations. Nevertheless, it is important to establish adequate procedures for ascertaining failures and giving opportunity for rectifying such failures. In some countries, the imposition of contractual penalties requires

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[2]For a discussion of remedies used in construction contracts for complex industrial works, see *UNCITRAL Legal Guide on Drawing Up Contracts for the Construction of Industrial Works* ..., chapter XVIII, "Delay, defects and other failures to perform".

findings of official inspections and other procedural steps, including the review of the contracting authority by senior officials prior to the imposition of more serious sanctions. Those procedures may be complemented by provisions distinguishing between defects that can be rectified and those that cannot, and setting down the corresponding procedures and remedies. It is usually advisable to require that the concessionaire be given notice requiring it to remedy the breach within a sufficient period. It may also be advisable to contemplate the payment of penalties or liquidated damages by the concessionaire in the event of breach to perform essential obligations and to clarify that no penalties apply in case of breach of secondary or ancillary obligations and for which other remedies may be obtained under national law. Furthermore, a performance monitoring system contemplating penalties or liquidated damages may be complemented by a scheme of bonuses payable to the concessionaire for improving over agreed terms.

82. While the contracting authority may protect itself against the consequences of default by the concessionaire through a variety of judicially enforceable contractual arrangements, the remedies available to the concessionaire may be subject to a number of limitations under the applicable law. Important limitations may derive from rules of law that recognize the immunity of governmental agencies from judicial suit and enforcement measures. Depending on the legal nature of the contracting authority or of other governmental agencies that assume obligations vis-à-vis the concessionaire, the latter may be deprived of the possibility of enforcing measures of execution to secure the fulfilment of obligations entered into by those public entities (see also chap. VII, "Settlement of disputes", ___). This situation makes it the more important to provide mechanisms to protect the concessionaire against the consequences of default by the contracting authority, for example by means of governmental guarantees covering specific events of default or guarantees provided by third parties, such as multilateral lending institutions (see also chapter II, "Project risks and government support", ____).

2. Step-in rights for the contracting authority

83. Some national laws expressly authorize the contracting authority to temporarily take over the operation of the facility, normally in case of failure to perform by the concessionaire, in particular where the contracting authority has a statutory duty to ensure the effective delivery at all times of the service concerned. In some legal systems, such a prerogative is considered to be inherent in most Government contracts and might be presumed to exist even without being expressly mentioned in legislation or in the project agreement.

84. It should be noted that the contracting authority's right to intervene, its "step-in right", is an extreme measure. Private investors may fear that the contracting authority may use it, or threaten to use it, in order to impose its own desires about the way in which the service is provided, or even to get control of the project assets. It is therefore advisable to define as clearly as possible the circumstances in which step-in rights can be exercised. It may be useful to clarify in the law that the contracting authority's intervention in the project is temporary and is intended to remedy a specific, urgent problem that the concessionaire has failed to remedy. The concessionaire should resume responsibility for service delivery once the emergency situation has been remedied. It is important to reserve the contracting authority's right to intervene to cases of severe failures of service and not merely in case of dissatisfaction about the concessionaire's performance.

85. The contracting authority's ability to step in may be limited in that it may be difficult immediately to identify and engage a subcontractor to carry out the actions that the contracting authority is stepping in to do. Furthermore, frequent interventions carry a risk of the reversion to the contracting authority of risks that have been transferred in the project agreement to the concessionaire. The concessionaire should not rely on the contracting authority to step in to deal with a particular risk instead of handling it itself, as required by the project agreement.

86. It is advisable to clarify in the project agreement which party bears the cost of an intervention by the contracting authority. In most cases, the concessionaire should bear the costs incurred by the contracting authority when the intervention is prompted by a performance failure attributable to the concessionaire's own fault. In some cases, to prevent disputes about liability and about the appropriate level of costs, the agreement may authorize the contracting authority to take steps to remedy the problem itself, and then charge the actual cost of having done so (including its own administrative costs) to the concessionaire. However, when such intervention takes place following the occurrence of an exempting impediment (see paras. 69-79), the parties might agree on a different solution, depending on how that particular risk has been allocated in the project agreement.

3. Step-in rights for the lenders and compulsory transfer of the concession

87. During the life of the project situations may arise where, because of default by the concessionaire or the occurrence of an extraordinary event outside of the concessionaire's control, it might be in the interest of the parties to avert termination of the project (see chap. VI, "End of project term, extension and termination", ___) by allowing the project to continue under the responsibility of a different concessionaire. The lenders, whose main security is the revenue generated by the project, are particularly concerned about the risk of interruption or termination of the project prior to repayment of the loans. In the event of default of or an impediment affecting the concessionaire, the lenders will be interested in ensuring that the work will not be left incomplete and that the concession will be operated profitably. The contracting authority, too, may be interested in allowing the project to be carried out by a new concessionaire, as an alternative for having to take it over and continue it under its own responsibility.

88. Clauses allowing the lenders to select, with the consent of the contracting authority, a new concessionaire to perform under the existing project agreement have been included in a number of recent agreements for large infrastructure projects. Such clauses are typically supplemented by a direct agreement between the contracting authority and the lenders who are providing finance to the concessionaire. The main purpose of such a direct agreement is to allow the lenders to avert termination by the contracting authority when the concessionaire is in default by substituting a concessionaire that will continue to perform under the project agreement in place of the concessionaire in default. Unlike the contracting authority's right to intervene, which relates to a specific, temporary and urgent failure of the service, lenders' step-in rights are for cases where the concessionaire's failure to provide the service is recurrent or apparently irremediable.

89. In the experience of countries that have recently made use of such direct agreements, it has been found that the ability to head off termination and provide an alternative concessionaire gives the lenders additional security against default by the concessionaire. At the same time, it provides the contracting authority an opportunity to avoid the disruption entailed by terminating the project agreement, thus maintaining continuity of service. In countries where the lenders may obtain a security interest over the entirety of the concessionaire's rights and interests under the project agreement (see chap. IV, "The project agreement", ___), there may be an implied step-in right, whenever a particular situation constitutes an event of default under the loan agreements.

90. However, in some countries, the implementation of such clauses may face difficulties in the absence of legislative authorization. The concessionaire's inability to carry out its obligations is usually a ground for the contracting authority to take over the operation of the facility or terminate the agreement (see chap. VI, "End of project term, extension and termination", ___). For the purpose of selecting a new concessionaire to succeed the defaulting one, the contracting authority often needs to follow the same procedures that applied to the selection of the original concessionaire, and it might not be possible for the contracting authority to agree in consultation with the lenders on engaging a new concessionaire that has not been selected pursuant to those procedures. On the other hand, even where the contracting authority is authorized to negotiate with a new

concessionaire under emergency conditions, a new project agreement might need to be entered into with the new concessionaire and there may be limitations for its ability to assume obligations of its predecessor.

91. Therefore, it may be useful to acknowledge in the law the contracting authority's right to enter into agreements with the lenders allowing them to appoint a new concessionaire to perform under the existing project agreement, when the concessionaire seriously fails to deliver the service required under the project agreement, or following the occurrence of other specified events that could justify the termination of the project agreement. The agreement between the contracting authority and the lenders should, *inter alia*, specify the following: the circumstances in which the lenders are permitted to substitute a new concessionaire; the procedures for the substitution of the concessionaire; the grounds for refusal by the contracting authority of a proposed substitute; and the obligations of the lenders to maintain the service at the same standards and on the same terms as required by the project agreement.

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PRIVATELY FINANCED INFRASTRUCTURE PROJECTS

Draft chapters of a legislative guide on privately financed infrastructure projects

Report of the Secretary-General

Addendum

VI. END OF PROJECT TERM, EXTENSION AND TERMINATION

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LEGISLATIVE RECOMMENDATIONS

1. Extension of the project agreement (see paras. 2-4)

1. The host country may wish to provide that the project agreement may be extended under exceptional circumstances, such as:

(a) To compensate for project suspension or loss of profit due to the occurrence of impeding events;

(b) To compensate for project suspension brought about by acts of the contracting authority or other government agencies;

(c) To allow the concessionaire to recover the cost of extraordinary work required on the facility and which the concessionaire would not be able to amortize during the normal term of the project agreement without unreasonable tariff increase.

2. Termination by the contracting authority (see paras. 10-23)

2. The host country may wish to provide that the contracting authority may terminate the project agreement:

(a) In the event of serious default by the concessionaire, in the circumstances provided in the project agreement, in particular if it can no longer be reasonably expected that the concessionaire will be able or willing to perform its obligations;

(b) In the event that the concessionaire is declared insolvent or bankrupt;

(c) For the contracting authority's convenience, subject to payment of fair compensation to the concessionaire.

3. The host country may wish to provide that before terminating the project agreement the contracting authority should, as appropriate:

(a) Grant the concessionaire an additional period of time to perform the obligation or remedy the consequences of its default;

(b) Give notice to the concessionaire's lenders and sureties, as appropriate, to remedy the consequences of the concessionaire's default within a reasonable time or to appoint a substitute concessionaire under the terms of their agreements with the contracting authority.

3. Termination by the concessionaire (see paras. 24-29)

4. The host country may wish to provide that the concessionaire may terminate the project agreement:

(a) In the event of serious default by the contracting authority or other agency of the host Government as regards the fulfilment of their obligations under the project agreement;

(b) In the event that the concessionaire's performance is rendered substantially more onerous as a result of variation orders made by the contracting authority or unforeseen changes in conditions and that the parties have failed to agree on an appropriate revision of the project agreement.

4. **Termination by either party (see paras. 30 and 31)**

5. The host country may wish to provide that the project agreement may also be terminated:

(a) In the event that the performance by either party is rendered impossible by the occurrence of exempting impediments;

(b) By mutual consent.

5. **Transfer of assets to the contracting authority (see paras. 34 and 35)**

6. The host country may wish to provide that the project agreement should:

(a) Identify the categories of assets that the concessionaire is required to transfer to the contracting authority upon expiry or termination of the project agreement and lay down the criteria for establishing, as appropriate, the compensation to which the concessionaire may be entitled in that respect;

(b) Identify the categories of assets that the contracting authority, at its option, may purchase from the concessionaire against payment of their fair market value;

(c) Identify the categories of assets that the concessionaire may freely remove or dispose of upon expiry or termination of the project agreement.

6. **Transfer of assets to a new concessionaire (see para. 36)**

7. The host country may wish to provide that the concessionaire may be required to make any of the assets referred to in subparagraphs 6 (a) and (b) above available to a new concessionaire against adequate compensation for those assets which have not been fully amortized during the project period.

7. **Financial arrangements upon termination (see paras. 39-45)**

8. The host country may wish to provide that the project agreement should stipulate how compensation due to the concessionaire in the event of termination of the project agreement is to be calculated, including:

(a) Compensation for the fair value of works performed under the project agreement if the project agreement is terminated for reasons attributable to the concessionaire;

(b) Compensation for the fair value of the works performed by as well as for the loss caused to the concessionaire, including lost profits, if the project agreement is terminated for reasons attributable to the contracting authority;

(c) Compensation for the fair value of the works performed by the concessionaire and other compensation that may be appropriate in the circumstances, if the project agreement is terminated due to the occurrence of exempting impediments or for the contracting authority's convenience.

8. **Wind-up and transitional measures (see paras. 46-58)**

9. The host country may wish to provide that the project agreement should set out the rights and obligations of the parties with respect to:

(a) The transfer of technology required for the operation of the facility;

(b) The training of the contracting authority's personnel in the operation and maintenance of the facility;

(c) The provision, by the concessionaire, of operation and maintenance services and the supply of spare parts, if required, for a reasonable period after the transfer of the facility to the contracting authority.

NOTES ON THE LEGISLATIVE RECOMMENDATIONS

A. General remarks

1. Most privately financed infrastructure projects are undertaken for a certain period, at the end of which the concessionaire transfers to the contracting authority responsibility for the operation of the infrastructure facility. The elements to be taken into account when establishing the concession period have been considered elsewhere in the *Guide* (see chap. IV, "The project agreement", ___). This chapter deals with issues arising in connection with the expiry or termination of the project agreement, which in many countries have been addressed in statutory provisions. Section B deals with the question of whether and under what circumstances the project agreement may be extended (see paras. 2-4). Section C considers circumstances that may authorize the termination of the project agreement prior to the expiry of its term (see paras. 5-31). Lastly, section D deals with the consequences of the expiry or termination of the project agreement, including the transfer of project assets and the compensation to which either party may be entitled upon termination and provisions for the wind-up of the project (see paras. 32-58).

B. Extension of the project agreement

2. In the contracting practice of some countries, the contracting authority and the concessionaire may agree on one or more extensions of the concession period. More often, however, domestic laws only authorize an extension of the project agreement under exceptional circumstances. In this case, upon expiry of the project agreement the contracting authority is normally required to begin a new selection process to select a new concessionaire, normally using the same procedures applied to select the concessionaire whose concession has expired (see chap. III, "Selection of the concessionaire", ___).

3. A number of countries have found it useful to require that exclusive concessions be rebid from time to time rather than freely extended by the parties. Periodic rebidding may give the concessionaire strong performance incentives. The period between the initial award and the first (and subsequent) rebidding should take into account the level of investment and other risks faced by the concessionaire. For example, for solid waste collection concessions not requiring heavy fixed investments, the periodicity may be relatively short (e.g. three to five years), whereas longer periods may be desirable for power or water distribution concessions, for example. In most countries, rebidding coincides with the end of the project term, but in others a concession may be granted for a long period (e.g. 99 years), with periodic rebidding (e.g. every 10 or 15 years). In the latter mechanism, which has been adopted in a few countries, the first rebidding occurs before the concessionaire has fully recouped its investments. As an incentive to the incumbent operator, some laws provide that the concessionaire may be given preference over other bidders in the award of subsequent concessions for the same activity. However, the concessionaire may have property rights that will need to be compensated for if it does not win the next bidding round, in which case all or part of the bidding proceeds may revert to the incumbent concessionaire. Requiring that the winning bidder should pay off the incumbent concessionaire for its property rights and for the investment not yet recovered reduces the longer-term risk faced by investors and lenders and provides them a valuable exit option.

4. Notwithstanding the above, it is advisable not to exclude entirely the option to negotiate an extension of the concession period under exceptional circumstances. The duration of an infrastructure project is one of the main factors taken into account in the negotiation of financial arrangements and has a direct impact on the price of the services provided by the concessionaire. The parties may find that an extension of the project agreement (as a substitute for, or combined with, other compensation mechanisms) may be a useful option to deal with unexpected or extraordinary circumstances arising during the life of the project. Such circumstances may include any of the following: extension to compensate for project suspension or loss of profit due to the

occurrence of impeding events (see chap. V, "Infrastructure development and operation", ___); extension to compensate for project suspension brought about by the contracting authority or other government agencies (see chap. V, "Infrastructure development and operation", ___); or extension to allow the concessionaire to recover the cost of extraordinary work required to be done on the facility and which the concessionaire would not be able to amortize during the normal term of the project agreement without unreasonable tariff increases (see chap. V, "Infrastructure development and operation", ___). For purposes of transparency and accountability, in some countries the extension of the concession period is subject to a global cumulative limit or requires the approval of a specially designated authority of the Government.

C. Termination

5. The grounds for termination of the project agreement before the expiry of its term and the consequences of early termination are often dealt with in domestic legislation. Usually the law authorizes the parties to terminate the project agreement following the occurrence of certain types of event. The main interest of all parties involved in a privately financed infrastructure project is to ensure the satisfactory completion of the facility and the continuous and orderly provision of the relevant public service. Given the serious consequences of termination, as provision of the service may be interrupted or even discontinued, termination should under most circumstances be regarded as a measure of last resort. The conditions for the exercise of this right by either party should be carefully considered. While they may not need to be identical, it is generally desirable to achieve a broadly equitable balance of rights and conditions regarding termination for both parties.

6. In addition to identifying the circumstances or types of event that may give rise to a termination right, it is advisable for the parties to consider appropriate procedures to establish whether there are valid grounds for terminating the project agreement. Of particular importance is the question whether the project agreement may be unilaterally terminated or whether termination requires a decision by a judicial or other dispute settlement body (see chap. VIII, "Settlement of disputes", ___).

7. The concessionaire is usually not allowed the right to terminate the project agreement unilaterally, but in the general contracting practice of some countries such a right may be exercised by government agencies, subject to payment of compensation. In some countries, however, an exception is made in the case of public services concessions, whose contractual nature is found to be incompatible with unilateral termination rights. Lastly, some legal systems do not recognize unilateral termination rights for government agencies. The contracting authority may find that a unilateral termination right is a powerful tool to encourage performance by the concessionaire. It may also find that unilateral termination rights save time in taking the necessary measures to ensure the continuity of the service upon irremediable default by the concessionaire. However, project sponsors and lenders would be concerned about the risk of premature or unjustified termination by the contracting authority, even where a decision to terminate might be subject to review through the dispute settlement mechanism. It should also be noted that giving the contracting authority the unilateral right to terminate the project agreement would not be an adequate substitute for well-designed contractual mechanisms of performance monitoring or for appropriate guarantees of performance (see chap. V, "Infrastructure development and operation", ___).

8. Provisions concerning termination should therefore be brought into line with the remedies for default provided in the project agreement. In particular, it is useful to distinguish the conditions for termination from those for step-in by the contracting authority (see chap. V, "Infrastructure development and operation", ___). It is also important to consider the contracting authority's termination rights against the background of the financing agreements negotiated by the concessionaire with its lenders. In most cases, events that may lead to the termination of the project agreement would also constitute events of default under the loan agreements, with the consequence that the entire outstanding debt of the concessionaire may fall due immediately. It would thus be useful to attempt to avoid the risk of termination by recourse first to a direct agreement, which would allow

the lenders to substitute another concessionaire when termination of the project agreement with the original concessionaire appears imminent (see chap. V, "Infrastructure development and operation", ___).

9. In the light of the above, it is generally advisable to provide that the termination of the project agreement should in most cases require a final finding by the dispute settlement body stipulated in the agreement. Such a requirement would reduce concerns about premature or unjustified recourse to termination. At the same time, it would not preclude the taking of appropriate measures to ensure the continuity of the service, pending the final decision of the dispute settlement body, as long as contractual remedies for default, such as step-in rights for the contracting authority and the lenders, are provided in the project agreement.

1. Termination by the contracting authority

10. The contracting authority's termination rights usually relate to three categories of circumstances: serious default by the concessionaire; insolvency or bankruptcy of the concessionaire; and termination for the contracting authority's convenience.

(a) Serious default by the concessionaire

11. A number of national laws give the contracting authority the right to terminate the project agreement in the event of default by the concessionaire. Because of the disruptive effects of termination and in the interest of preserving the continuity of the service, it is not advisable to regard termination as a sanction for each and any instance of unsatisfactory performance by the concessionaire. On the contrary, it is generally advisable to resort to the extreme remedy of termination only in cases of "particularly serious" or "repeated" failures to perform, especially when it can no longer be reasonably expected that the concessionaire will be able or willing to perform under the project agreement. Many legal systems use specific technical expressions to refer to situations where the degree of default by one contracting party is of such a nature that the other party may terminate their contractual relation before the expiry of its term (e.g. "fundamental breach", "material breach" or similar expressions). Such situations are referred to in the *Guide* as "serious default".

12. Circumscribing the possibility of termination to cases of serious default may give assurance to lenders and project sponsors that they will be protected against unreasonable or premature decisions by the contracting authority. The law may generally provide for the contracting authority's right to terminate the project agreement upon serious default by the concessionaire and leave it for the project agreement to define further the notion of serious default and, as appropriate, provide illustrative examples of it. From a practical point of view, it is not advisable to attempt, by statute or in the project agreement, to provide an exhaustive list of the events that justify termination.

13. As a general rule, it is desirable that the concessionaire be granted an additional period of time to fulfil its obligations and to parry the consequences of its default prior to the contracting authority's resorting to remedies. For example, the concessionaire should be given notice specifying the nature of the relevant circumstances and requiring it to rectify them within a certain period. The possibility should also be given for the lenders and sureties, as the case may be, to parry the consequences of the concessionaire's default in accordance with the terms of a direct agreement between the lenders and the contracting authority or the terms of the performance bonds provided to the contracting authority (see chap. V, "Infrastructure development and operation", ___). The project agreement may also provide that, if the circumstances are not rectified before the expiry of the relevant period, the contracting authority may then terminate the project agreement, subject to first notifying the lenders and giving them an opportunity to exercise their right of substitution within a certain period in accordance with the relevant procedure provided in the direct agreement. However, reasonable deadlines need to be set, since the contracting authority cannot be expected to bear indefinitely the continuing cost of a situation of potential breach of agreement by the concessionaire. Furthermore, the procedures should be without prejudice to the

contracting authority's right to step in to avert the risk of disruption of service by the concessionaire (see chap. V, "Infrastructure development and operation", ___).

(i) Serious default before the beginning of construction

14. The concessionaire typically needs to accomplish a series of steps prior to undertaking construction works. Such requirements are often conceived as conditions to the entry into force of the project agreement. Examples of events that often justify the withdrawal of the concession at an early stage include the following:

(a) Failure to secure the required financial means, to sign the project agreement or to establish the project company within the established deadline;

(b) Failure to obtain licences or permits required for pursuing the activity that is the object of the concession;

(c) Failure to undertake the construction of the facility, to commence development of the project or to submit the plans and designs required within a set period of time from the award of the concession.

15. Termination should in principle be reserved for situations where the contracting authority may no longer reasonably expect that the selected concessionaire will take the necessary measures to commence execution of the project. In that connection, it is important for the contracting authority to take into account any circumstances that may excuse the concessionaire's delay in fulfilling its obligations. Furthermore, the concessionaire should not suffer the consequences of inaction or error on the part of the contracting authority or other government agencies. For instance, the termination of the project agreement would not normally be justified if the concessionaire's failure to obtain government licences and permits within the agreed schedule was not attributable to the concessionaire's own fault.

(ii) Serious default during the construction phase

16. Examples of events that may justify the termination of the project agreement during the construction phase include the following:

(a) Failure to observe building regulations, specifications or minimum design and performance standards and non-excusable failure to complete work within the agreed schedule;

(b) Failure to provide or renew the required guarantees in the agreed terms;

(c) Violation of essential statutory or contractual obligations, as provided in the project agreement.

17. Termination should be commensurate with the degree of default by the concessionaire and the consequences of default for the contracting authority. For instance, the contracting authority may have a legitimate interest in specifying a date when the construction must be completed and may therefore be justified in regarding a delay in completion as an event of default and hence a ground for termination. However, delay alone, in particular if it is not excessive in relation to the specifications of the project agreement, should not be sufficient reason for termination when the contracting authority is otherwise satisfied of the concessionaire's ability to complete the construction in accordance with the required quality standards and its commitment to doing so.

(iii) Serious default during the operational phase

18. Examples of particular instances of default that may justify the termination of the concession during the operational phase include any of the following:

(a) Serious failure to provide services in accordance with the statutory and contractual standards of quality;

(b) Non-excusable suspension or interruption of the provision of the service without prior consent from the contracting authority;

(c) Serious failure by the concessionaire to maintain the facility, its equipment and appurtenances in accordance with the agreed standards of quality or non-excusable delay in carrying out maintenance works in accordance with the agreed plans, schedules and timetables;

(d) Disregard of price control measures, if any, or other serious violation of rules, regulations or contractual provisions governing the provision of the service;

(e) Failure to comply with sanctions imposed by the contracting authority or the regulatory body, as appropriate, for infringements of the concessionaire's duties.

19. For the purpose of enhancing transparency and integrity in governmental matters, the laws of some countries also provide for the termination of project agreements if the concessionaire is guilty of tax fraud or other types of fraudulent acts, or if its agents or employees are involved in bribery of public officials and other corrupt practices (see also chap. VII, "Governing law", ___). In such cases it may be advisable to consider the extent to which the concessionaire actually initiates any such corrupt acts in order to influence the decisions of public officials in the concessionaire's favour or whether illegal payments are made following irresistible demands or threats by officials of the host country (a crime sometimes referred to as "extortion").

(b) Insolvency of the concessionaire

20. Infrastructure services typically need to be provided continuously and for that reason most domestic laws stipulate that the agreement may be terminated if the concessionaire is declared insolvent or bankrupt. In order to ensure the continuity of the service, the assets and property required to be handed over to the contracting authority may be excluded from the insolvency proceedings and the law may require prior governmental approval for any act of disposition by a liquidator or insolvency administrator of any categories of assets owned by the concessionaire.

21. In legal systems that allow the establishment of security interests over the concession itself (see chap. IV, "The project agreement", ___), the law usually provides that the contracting authority may, in consultation with the secured creditors, appoint a temporary administrator so as to ensure the continued provision of the relevant service, until the secured creditors admitted to the insolvency proceedings decide, upon the recommendation of the insolvency administrator, whether the activity should be pursued or whether the right to exploit the concession should be put to auction.

(c) Termination for convenience

22. In the contracting practice of some countries, government agencies procuring construction works traditionally retain the right to terminate the construction contract for convenience (i.e. without having to provide any justification other than that the termination is in the Government's interest). In some common law

jurisdictions, that right can only be exercised if expressly provided for in a statute or in the relevant contract. Several legal systems belonging to the civil law tradition also recognize a similar power of government agencies to terminate contracts for reasons of "public interest" or "general interest". In some countries, such a right may be implied in the Government's contracting authority, even in the absence of an explicit statutory or contractual provision to that effect. In so far as the authority to determine what constitutes public interest may lie within the Government's discretion, an unqualified right to terminate for reasons of public interest is comparable to a termination for the contracting authority's convenience. The Government's right to terminate for convenience or for reasons of public interest, in those legal systems which recognize it, is regarded as essential in order to preserve the Government's unfettered ability to exercise its functions affecting the public good.

23. Nevertheless, the conditions for the exercise of this right, and the consequences of doing so, should be carefully considered. A general and unqualified right to terminate for the contracting authority's convenience may represent an imponderable risk that neither the concessionaire nor the lenders may be ready to accept without sufficient guarantees that they will receive prompt and fair compensation for loss sustained. The possibility of termination for convenience, where contemplated, should therefore be made known to prospective investors at the earliest possible occasion and should be expressly mentioned in the draft project agreement circulated with the request for proposals (see chap. III, "Selection of the concessionaire", ___). The compensation due for termination for convenience may, in practice, cover items that are taken into account when calculating the compensation that is due for termination for serious default by the contracting authority (see para. 42). Furthermore, it is generally advisable to limit the exercise of the right of termination for convenience to exceptional situations where a compelling reason of public interest requires the termination of the project agreement (for example, where subsequent changes in governmental plans and policies require the integration of a project into a larger network or where changes in the contracting authority's plans require major project revisions that substantially affect the original design or the project's commercial feasibility under private operation). In particular, it is not advisable to regard the right of termination for convenience as a substitute for other contractual remedies in case of dissatisfaction with the concessionaire's performance (see chap. V, "Infrastructure development and operation", ___).

2. Termination by the concessionaire

24. While the contracting authority in some legal systems may retain an unqualified right to terminate the project agreement, the grounds for termination by the concessionaire are usually limited to serious default by the contracting authority or other exceptional situations and do not normally include a general right to terminate the project agreement at will.

(a) Serious default by the contracting authority

25. Pursuant to a rule of law followed in many legal systems, a party to a contract may withhold performance of its obligations in the event of breach by the other party. In some legal systems that rule does not apply to government contracts, however, and the law provides instead that government contractors are not excused from performing solely on the ground of breach by the contracting authority unless and until the contract is rescinded by a judicial or arbitral decision. Rules of this type may be intended to ensure the continuity of public services (see chap. V, "Infrastructure development and operation", ___).

26. It should be noted, however, that while the contracting authority may mitigate the consequences of default by the concessionaire by using its right to step in, the concessionaire does not usually have a comparable remedy. In the event of serious default by the contracting authority, the concessionaire may sustain considerable or even irreparable damage, depending on the time required to obtain a final decision releasing the concessionaire from its obligations under the project agreement. These circumstances underscore the importance of government guarantees in respect of obligations assumed by contracting authorities (see chap. II,

"Government support", ___) and the need for allowing the parties the choice of expeditious and effective dispute settlement mechanisms (see chap. VIII, "Settlement of disputes", ___).

27. In those legal systems where the contracting authority has the right to request modifications in the project, some laws give the concessionaire the right to terminate the project agreement if the contracting authority alters or modifies the original project in such a fashion as to cause a substantial increase in the amount of investment required and the parties fail to agree on the appropriate amount of compensation (see chap. V, "Infrastructure development and operation", ___).

28. In addition to serious default by the contracting authority itself, it may be equitable to authorize termination by the concessionaire should the latter be rendered unable to provide the service as a result of acts of government agencies other than the contracting authority, such as failure to provide certain measures of support required for the execution of the project agreement (see chap. II, "Government support", ___).

(b) Changes in conditions

29. Some legal systems allow the concessionaire to terminate the project agreement if the concessionaire's performance has been rendered substantially more onerous by the occurrence of an unforeseen change in conditions and the parties have failed to agree on an appropriate revision to adapt the project agreement to the changed conditions (see chap. V, "Infrastructure development and operation", ___).

3. Termination by either party

(a) Impediment of performance

30. Some laws provide that the parties may terminate the project agreement if the performance of their obligations is rendered permanently impossible as a result of a circumstance defined in the project agreement as an exempting impediment (see chap. V, "Infrastructure development and operation", ___). In that connection, it is advisable to provide in the project agreement that if the exempting impediment persists for a specified amount of time or if the cumulative duration of two or more exempting impediments exceeds a specified amount of time, the contract may be terminated by either party. If the execution of the project is further rendered impossible on legal grounds, for instance, because of changes in legislation or as a result of judicial decisions affecting the validity of the project agreement, such a termination right might not require any specified amount of time to elapse and might be exercised immediately upon the change of legislation or other legal obstacle becoming effective.

(b) Mutual consent

31. Lastly, some legal systems authorize the parties to terminate the project agreement by mutual consent, usually subject to the approval of a specified authority of the Government.

D. Consequences of expiry or termination of the project agreement

32. The concessionaire's right to operate the facility and to provide the relevant service typically finishes upon expiry of the project term or termination of the project agreement. This often requires the transfer of assets to the contracting authority or to another concessionaire who undertakes to operate the facility (see paras. 33-38). There may be important financial consequences that will need to be regulated in detail in the project agreement, in particular in the event of termination by either party (see paras. 39-45). The parties will also need to agree on various wind-up measures to ensure the orderly transfer of the responsibility for operating the facility and providing the service (see paras. 46-58).

1. Transfer of project-related assets

33. A number of laws provide that, upon termination of the concession, the assets and property originally made available to the concessionaire and other goods related to the project should revert to the contracting authority. However, there may be projects where the concessionaire is not required to hand over the assets to the contracting authority, for instance, because it owns those assets or because the assets are transferred directly from the concessionaire to another concessionaire who succeeds it in the provision of the service.

(a) Transfer of assets to the contracting authority

34. The laws of some countries place particular emphasis on the contracting authority's interest in the physical assets related to the project and generally require the handover to the contracting authority of all of them, whereas in other countries privately financed infrastructure projects are regarded primarily as a means for procuring services over a specified period, rather than for the construction of assets. Thus, the laws of the latter countries limit the concessionaire's handover obligations to particular categories of assets deemed to be necessary for ensuring the provision of the service. This difference in legislative approaches often reflects the varying role of the public and private sectors under different legal and economic systems, but may also be the result of practical considerations on the part of the contracting authority.

35. One practical reason for the contracting authority to allow the concessionaire to retain certain assets at the end of the project period may be the desire to lower the cost at which the service would be provided. If the project assets are likely to have a residual value for the concessionaire and that value can be taken into account during the selection process, the contracting authority may expect that the price charged for the service will be lower. Indeed, if the concessionaire does not expect to have to cover the entire cost of the assets in the life of the project, but can cover part of it by selling them on, or using them for other purposes, after the project agreement expires, there is a possibility that the service may be provided at a lower cost than if the concessionaire had to cover all the costs in the life of the project. Moreover, certain assets may require such extensive refurbishing or technological upgrading at the end of the project period that it might not be cost-effective for the contracting authority to claim them. There may also be residual liabilities or consequential costs, for instance, because of liability for environmental damage or demolition costs. For these reasons, therefore, the laws of some countries do not contemplate an unqualified transfer of all assets to the contracting authority, but allow a distinction between three main categories of assets:

(a) *Assets that must be transferred to the contracting authority.* This category typically includes assets owned by the contracting authority or other agency of the host Government that were used by the concessionaire to provide the service concerned. They may include both facilities made available to the concessionaire by the contracting authority and new facilities built by the concessionaire pursuant to the project agreement. Some laws also require the transfer of assets, goods and property subsequently acquired by the concessionaire for the purpose of operating the facility, in particular where they become part of, or are permanently affixed to, the infrastructure facility to be handed over to the contracting authority. In the legal tradition of some countries, at the end of the project term, the concessionaire is required to transfer such assets free of any liens and encumbrances and at no cost to the contracting authority, except for compensation for improvements made to, or modernization of, the property for the purpose of ensuring the continuity of the service the cost of which has not yet been recovered by the concessionaire. In practice, such a rule presupposes the negotiation of a concession period sufficiently long and a level of revenue high enough for the concessionaire to fully amortize its investment and repay its debt. Other laws allow for more flexibility by authorizing the contracting authority to compensate the concessionaire for the residual value, if any, of assets built by the concessionaire;

(b) *Assets that may be purchased by the contracting authority, at its option.* This category usually includes assets originally owned by the concessionaire, or subsequently acquired by it, which, without being

indispensable or strictly necessary for the provision of the service, may enhance the convenience or efficiency of operating the facility or the quality of the service. If the contracting authority decides to exercise its option to purchase those assets, the concessionaire is normally entitled to compensation corresponding to their fair market value at the time. However, if those assets were expected to be fully amortized (i.e. the concessionaire's financing arrangements do not envisage any expectation of residual value of the assets), then the price paid might be only nominal. In the contracting practice of some countries, it is usual for contracting authorities to retain some security interest in such assets (such as a retention right), as a guarantee for their effective transfer;

(c) *Assets that remain the private property of the concessionaire*. These are assets owned by the concessionaire that do not fall under (b) above. Typically the contracting authority is not entitled to such assets, which may be freely removed or disposed of by the concessionaire.

(b) Transfer of assets to a new concessionaire

36. As indicated earlier, the contracting authority may wish to rebid the concession at the end of the project agreement, rather than to operate the facility itself (see para. 3). For that purpose, it may be useful for the law to require the concessionaire to make the assets available to a new concessionaire. In order to ensure an orderly transition and continuity of the service, the concessionaire should be required to cooperate with the new concessionaire in the handover. The transfer of assets between the concessionaires may require that some compensation be paid to the incumbent concessionaire, depending on whether or not the assets have been amortized during the life of the project:

(a) *Compensation at fair market value*. The concessionaire may be entitled to compensation for assets handed over to a successor concessionaire, in particular if its original proposal envisaged some residual value for the assets at the end of the project period, or if the financial proposal assumes significant revenue from third parties;

(b) *Nominal compensation*. If an element of residual value or third-party revenue is not envisaged in the concessionaire's financing, there may not be a prima facie reason for requiring a successor concessionaire to pay any compensation to the original concessionaire other than a nominal consideration. Indeed, if the concessionaire has achieved its expected return, a transfer payment from a successor concessionaire would be an additional cost that would ultimately have to be remunerated by the prices charged by the successor under the second agreement.

(c) Condition of assets at the time of transfer

37. Where assets are handed over to the contracting authority or transferred directly to a new concessionaire, the concessionaire is typically obligated to transfer them in good and operating condition, free of liens or encumbrances. The contracting authority's right to receive those assets in such operating condition is complemented in some laws by the obligation imposed upon the concessionaire to keep and transfer the project in such proper condition as prudent maintenance requires and to provide some sort of guarantee to that effect (see chap. V, "Infrastructure development and operation", ___). Where the contracting authority requires the assets to be returned in a prescribed condition, the required conditions should be reasonable. While it may be reasonable for the contracting authority to require that the assets have some defined period of residual life, it would not be reasonable to expect them to be as new.

38. It is advisable to devise procedures for ascertaining the condition of the assets that should be transferred to the contracting authority. It may be useful, for example, to establish a committee comprised of representatives of both the contracting authority and the concessionaire to establish whether the facilities are in the prescribed condition and conform to the relevant requirements set forth in the project agreement. The project agreement

may also provide for the appointment and terms of reference of such a committee, which may be given authority to request reasonable measures by the concessionaire to repair or eliminate any defects and deficiencies found in the facilities. It may be advisable to provide for a special inspection to take place one year prior to the termination of the concession, following which the contracting authority may require additional maintenance measures by the concessionaire so as to ensure that the goods are in proper condition at the time of the transfer. The contracting authority may wish to require that the concessionaire provide special guarantees for the satisfactory handover of the facilities (see chap. V, "Infrastructure development and operation", ___). The contracting authority might draw on such guarantees to pay the repair cost of damaged assets or property.

2. Financial arrangements upon termination

39. The early termination of the project agreement may occur before the concessionaire has been able to recover its investment, repay its debt and yield the expected profit, which may cause significant loss to the concessionaire. Loss may also be sustained by the contracting authority, which may need to make additional investment or incur considerable expense in order, for instance, to ensure the completion of the facility or the continued provision of the relevant services. In the light of these circumstances, project agreements typically contain extensive provisions dealing with the financial rights and obligations of the parties upon termination. The usual standards of compensation typically vary according to the various grounds for termination. Nevertheless, when negotiating compensation arrangements, the parties usually take into account the following factors:

(a) *Outstanding debt, equity investment and anticipated profit*. Project termination is typically included among the events of default in the concessionaire's loan agreements. Since loan agreements usually include a so-called "acceleration clause" whereby the entire debt may become due upon the occurrence of an event of default, the immediate loss sustained by the concessionaire upon termination of the project agreement may include the amount of debt then outstanding. Whether and to what extent such a loss might be compensated for by the contracting authority usually depends on the grounds for terminating the project agreement. Partial compensation may be limited to an amount corresponding to the value of works satisfactorily performed by the concessionaire, whereas full compensation may cover the entire outstanding debt. Another category of loss that is sometimes taken into account in compensation arrangements refers to loss of equity investment by the project sponsors, to the extent that such an investment has not yet been recovered at the time of termination. Lastly, termination also deprives the concessionaire of future profits that the facility may generate. Although lost profits are not usually regarded as actual damage, in exceptional circumstances, such as wrongful termination by the contracting authority, the current value of expected future profit may be included in the compensation due to the concessionaire;

(b) *Degree of completion, residual value and amortization of assets*. Contractual compensation schemes for various termination grounds typically include compensation commensurate with the degree of completion of the works at the time of termination. The value of the works is usually determined on the basis of the investment required for its construction (in particular if the termination takes place during the construction phase) or the "residual" value of the facility. The residual value means the market value of the infrastructure at the time of termination. Market value may be difficult to determine or even inexistent for certain types of physical infrastructure (such as bridges or roads) or for facilities whose operational life is close to expiry. Sometimes the residual value may be estimated taking into account the expected usefulness of the facility for the contracting authority. However, difficulties may be found in establishing the value of unfinished works, in particular if the amount of the investment still required by the contracting authority to render the facility operational would exceed the amount actually invested by the concessionaire. In any event, full payment of residual value seldom takes place, in particular where the project's revenue constitutes the sole remuneration for the concessionaire's investment. Thus, instead of full compensation for the facility's value, the concessionaire often receives compensation only for the residual value of assets that have not yet been fully

amortized at the time of termination. The notion of economic "amortization", in this context, refers to the gradual charging of the investment made against project revenue on the assumption that the facility would have no residual value at the end of the project term.

(a) Termination due to default by the concessionaire

40. The concessionaire is not usually entitled to damages in the event of termination due to its own default. In some cases the concessionaire may even be under an obligation to pay damages to the contracting authority, although, in practice, a defaulting concessionaire whose debts are declared due by its creditors would seldom have sufficient financial means left for actually paying such damages.

41. Termination due to default, even where it is regarded as a sanction for serious performance failures, should not result in the unjust enrichment of either party. Thus, termination does not necessarily entail a right for the contracting authority to take over assets without making any payment to the concessionaire. An equitable solution for dealing with this issue may be to distinguish between the different types of asset, according to the arrangements envisaged for them in the project agreement (see para. 35):

(a) *Assets that must be transferred to the contracting authority.* Where the project agreement requires the automatic transfer of project assets to the contracting authority at the end of the project agreement, termination on default does not usually entail the payment of compensation to the concessionaire for those assets, except for the residual value of work satisfactorily performed, to the extent that it has not yet been amortized by the concessionaire;

(b) *Assets that may be purchased by the contracting authority, at its option.* Some financial compensation may be adequate in cases where the contracting authority has an option to buy the assets at market value or for a nominal sum on expiry of the project agreement or the right to require that they be offered to the winner of a new project award. However, it may be legitimate to envisage a financial compensation that is less than the full value of the assets so as to stimulate performance by the concessionaire. By the same token, such compensation may not need to cover the full cost of repaying the concessionaire's outstanding debt. It is advisable to set forth the details of the formula for financial compensation in the project agreement (e.g. whether it covers the break-up value of the asset or the lesser of the outstanding debt and the alternative use value);

(c) *Assets that remain the private property of the concessionaire.* Where the project agreement does not provide for the handover of assets at the end of the concession period and alternative suppliers of the service can easily be found, the contracting authority may not have an interest in taking over the concessionaire's assets. However, where the contracting authority finds it necessary to take over the assets, even though not contemplated in the project agreement, it would be equitable to compensate the concessionaire for the fair market value of the assets. The project agreement may, however, provide that the compensation should be reduced by the amount incurred by the contracting authority in obtaining alternative service.

(b) Termination due to default by the contracting authority

42. The concessionaire is usually entitled to full compensation for loss sustained as a result of termination on grounds attributable to the contracting authority. The compensation due to the concessionaire usually includes compensation for the value of the works and installations, to the extent they have not already been amortized, as well as for the damage caused to the concessionaire, including lost profits, which are usually calculated on the basis of the concessionaire's revenue during previous financial years. The concessionaire may be entitled to full compensation of debt and equity, including debt service and lost profit.

(c) Termination on other grounds

43. When considering compensation arrangements for termination due to circumstances unrelated to default by either party, it may be useful to distinguish exempting impediments from termination declared by the contracting authority for reasons such as public interest or other similar reasons.

(i) Termination due to exempting impediments

44. By definition, exempting impediments are events beyond the parties' control and, as a general rule, termination under such circumstances might not give rise to claims for damages by either party. However, there may be circumstances where it might be equitable to provide for some compensation to the concessionaire, such as fair compensation for works already completed, in particular where, because of the specialized nature of the assets, they cannot be removed by the concessionaire or meaningfully used by it, but may be effectively used by the contracting authority for the purpose of providing the relevant service (e.g. a bridge). However, since termination in such cases cannot be attributed to the contracting authority, the compensation due to the concessionaire may not necessarily need to be "full" compensation (i.e. repayment of debt, equity and lost profits).

(ii) Termination for convenience

45. Where the project agreement recognizes the contracting authority's right to terminate for its convenience, the compensation payable to the concessionaire usually covers compensation for the same items included in compensation payable upon termination for default by the contracting authority (see para. 42), although not necessarily to the full extent. In order to establish the equitable amount of compensation due to the concessionaire, it may be useful to distinguish between termination for convenience during the construction phase and termination for convenience during the operational phase:

(a) *Termination for convenience during the construction phase.* If the project agreement is terminated during the construction phase, the compensation arrangements may be similar to those which are followed in connection with large construction contracts that allow for termination for convenience. In those cases, the contractor is usually entitled to the portion of the price that is attributable to the construction satisfactorily performed, as well as for expenses and losses incurred by the contractor arising from the termination. However, since the contracting authority does not normally pay a price for the construction work carried out by the concessionaire, the main criterion for calculating compensation would typically be the total investment effectively made by the concessionaire up to the time of termination, including all sums actually disbursed under the loan facilities extended by the lenders to the concessionaire for the purpose of carrying out construction under the project agreement, and expenses related to the cancellation of loan agreements. One additional question is whether and to what extent the concessionaire may be entitled to recover lost profit for the portion of the contract that has been terminated for convenience. On the one hand, the concessionaire might have foregone other business opportunities in anticipation of completing the project and operating the facility through the anticipated duration of the concession. On the other hand, an obligation of the contracting authority to compensate the concessionaire for its lost profit might make it financially prohibitive for the contracting authority to exercise its right of termination for convenience. One approach may be for the project agreement to establish a scale of payments to be made by the contracting authority as compensation for lost profits, the amount of the payments depending upon the stage of the construction that has been completed when the project agreement is terminated for convenience. It should be noted, however, that in the contract practice of some countries, government agencies do not assume any obligation to compensate for lost profits when a large construction contract is terminated for convenience;

(b) *Termination for convenience during the operational phase*. As regards the construction work satisfactorily completed by the concessionaire, the compensation arrangements may be the same as for termination for convenience during the construction phase. However, equitable compensation for termination for convenience during the operational phase might require fair compensation for lost profits, which is usually calculated on the basis of the concessionaire's revenue during a certain number of previous financial years. The higher standard of compensation in this case may be justified by the fact that, unlike termination during the construction phase, when the contracting authority might need to undertake to complete the work at its own expense, upon termination during the operational phase the contracting authority might be able to receive a completed facility capable of being operated profitably.

3. Wind-up and transitional measures

46. Where the facility is transferred to the contracting authority at the end of the concession period, the parties may need to make a series of arrangements in order to ensure that the contracting authority will be able to operate the facility at the prescribed standards of efficiency and safety. The project agreement may provide for the concessionaire's obligation to transfer certain technology or know-how required to operate the infrastructure facility (see paras. 47-51). The project agreement may also provide for the continuation, for a certain transitional period, of certain obligations of the concessionaire in respect of the operation and maintenance of the facility (see paras. 52-54). It may further include an obligation, on the part of the concessionaire, to supply or facilitate the supply of spare parts that may be needed by the contracting authority to carry out repairs in the facility (see paras. 55-58).

(a) Transfer of technology

47. In some cases, the facility transferred to the contracting authority will embody various technological processes necessary for the generation of certain goods (e.g. electricity or potable water) or the provision of the relevant services (e.g. telephone services). The contracting authority will often wish to acquire a knowledge of those processes and their application. The contracting authority will also wish to acquire the technical information and skills necessary for the operation and maintenance of the facility. Even where the contracting authority has the basic capability to undertake certain elements of the operation and maintenance (e.g. building or civil engineering), the contracting authority may need to acquire a knowledge of special technical processes necessary to effect the operation in a manner appropriate to the facility in question. The communication to the contracting authority of that knowledge, information and skills is often referred to as the "transfer of technology".

48. Differing contractual arrangements can be adopted for the transfer of technology and the performance of the other obligations necessary to construct and operate the facility. The transfer of technology itself may occur in different ways, for example, through the licensing of industrial property, through the creation of a joint venture between the parties or the supply of confidential know-how. The *Guide* does not attempt to deal comprehensively with contract negotiation and drafting relating to the licensing of industrial property or the supply of know-how, as this subject has already been dealt with in detail in publications issued by other United Nations bodies.[1] The following paragraphs merely note certain major issues concerning the communication of

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[1]The negotiation and drafting of contracts for the licensing of industrial property and the supply of know-how is dealt with in detail in World Intellectual Property Organization, *Licensing Guide for Developing Countries* (WIPO publication No. 620 (E), 1977). The main issues to be considered in negotiating and drafting such contracts are set forth in the *Guidelines for Evaluation of Transfer of Technology Agreements*, Development and Transfer of Technology Series, No. 12 (ID/233, 1979), and in the *Guide for Use in Drawing Up Contracts Relating to the International Transfer of Know-How in the Engineering Industry* (United Nations publication, Sales No. E.70.II.E.15). Another relevant publication is the *Handbook on the Acquisition of Technology by Developing Countries* (United Nations publication, Sales No. E.78.II.D.15).

skills necessary for the operation and maintenance of the facility through the training of the contracting authority's personnel or through documentation.

49. The most important method of conveying to the contracting authority the technical information and skills necessary for the proper operation and maintenance of the works is the training of the contracting authority's personnel. In order to enable the contracting authority to decide on its training requirements, in the request for proposals or during the contract negotiations the contracting authority might request the concessionaire to supply the contracting authority with an organizational chart showing the personnel requirements for the operation and maintenance of the works, including the basic technical and other qualifications the personnel must possess. Such a statement of requirements should be sufficiently detailed to enable the contracting authority to determine the extent of training required in the light of the personnel available to it. The concessionaire will often have the capability to provide the training. In some cases, however, the training may be given more effectively by a consulting engineer or through an institution specializing in training.

50. Technical information and skills necessary for the proper operation and maintenance of the facility may also be conveyed through the supply of technical documentation. The documentation to be supplied may consist of plans, drawings, formulae, manuals of operation and maintenance and safety instructions. It may be advisable to list in the project agreement the documents to be supplied. The concessionaire may be required to supply documents that are comprehensive and clearly drafted, and are in a specified language. It may be advisable to obligate the concessionaire, at the request of the contracting authority, to give demonstrations of procedures described in the documentation if the procedures cannot be understood without demonstrations.

51. The points in time when the documentation is to be supplied may be specified. The project agreement may provide that the supply of all documentation is to be completed by the time fixed in the contract for completion of the construction. The parties may also wish to provide that transfer of the facility is not to be considered completed unless all documentation relating to the operation of the works and required under the contract to be delivered prior to the completion has been supplied. It may be advisable to provide that some documentation (e.g. operating manuals) is to be supplied during the course of construction, as such documentation may enable the contracting authority's personnel or engineer to obtain an understanding of the working of machinery or equipment while it is being erected.

(b) Assistance in connection with operation and maintenance of the facility after its transfer

52. The degree of assistance from the concessionaire needed by the contracting authority with regard to the supply of spare parts and services will depend on the technology and skilled personnel possessed by or available to the contracting authority. If the contracting authority lacks personnel sufficiently skilled for the technical operation of the facility, it may wish to obtain the concessionaire's assistance in operating the facility, at least for an initial period. The contracting authority may, in some cases, wish the concessionaire to provide the personnel to occupy many of the technical posts in the facility, while in other cases the contracting authority may wish the concessionaire only to provide technical experts to collaborate in an advisory capacity with the contracting authority's personnel in the performance of a few highly specialized operations.

53. In order to assist the contracting authority in operating and maintaining the facility, the project agreement may obligate the concessionaire to submit, prior to the transfer of the facility, an operation and maintenance programme designed to keep the facility operating over its remaining lifetime at the level of efficiency required under the project agreement. An operation and maintenance programme would include matters such as an

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For a discussion of transfer of technology in the context of contracts for the construction of industrial works, see *UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (United Nations publication, Sales No. E.87.V.10), chap. VI, "Transfer of technology".

organizational chart showing the key personnel required for the technical operation of the facility and the functions to be discharged by each person; periodic inspection of the facility; lubrication, cleaning and adjustment; and replacement of defective or worn-out parts. Maintenance may also include operations of an organizational character, such as establishing a maintenance schedule or maintenance records. The concessionaire may also be required by the contracting authority to supply operation and maintenance manuals setting out appropriate operation and maintenance procedures. Those manuals should be in a format and language readily understood by the contracting authority's personnel.

54. An effective means of training the contracting authority's personnel in operation and maintenance procedures may be to provide in the project agreement that the personnel of the contracting authority are to be associated with the personnel of the concessionaire in carrying out the operation and maintenance for a certain time prior to or beyond the transfer of the facility. The positions to be occupied by the personnel employed by the concessionaire can then be identified and their qualifications and experience specified. The functions assigned to posts to be filled by employees of the concessionaire need to be defined with particular care. In order to avoid friction and inefficiency, it is desirable that any authority to be exercised by the personnel of each party over the personnel of the other during the relevant period be clearly described.

(c) Supplies of spare parts

55. In projects that provide for the transfer of the facility to the contracting authority, the contracting authority will have to obtain spare parts to replace those which are worn out or damaged and to maintain, repair and operate the facility. Spare parts may not be available locally or from any other source and the contracting authority may have to depend on the concessionaire to supply them. The planning of the parties with respect to the supply of spare parts and services after the transfer of the facility would be greatly facilitated if the parties were to anticipate and provide in the project agreement for the needs of the contracting authority in that regard. However, given the long duration of most infrastructure projects, it may be difficult for the parties to anticipate and provide in the project agreement for the needs of the contracting authority after the transfer of the facility.

56. A possible approach may be for the parties to enter into a separate contract regulating these matters.[2] Such a contract may be entered into closer in time to the transfer of the facility, when the contracting authority may have a clearer view of its requirements. If spare parts are manufactured not by the concessionaire but for the concessionaire by suppliers, the contracting authority may prefer to enter into contracts with those suppliers rather than to obtain them from the concessionaire or, alternatively, the contracting authority may wish to have the concessionaire procure them as the contracting authority's agent.

57. It is desirable for the contracting authority's personnel to develop the technical capacity to install the spare parts. For this purpose, the project agreement may obligate the concessionaire to supply the necessary instruction manuals, tools and equipment. The instruction manuals should be in a format and language readily understood by the contracting authority's personnel. The contract may also require the concessionaire to furnish "as built" drawings indicating how the various pieces of equipment interconnect and how access can be obtained to them to enable the spare parts to be installed and to enable maintenance and repairs to be carried out. In certain cases, it may be appropriate for the concessionaire to be required to train the contracting authority's personnel in the installation of spare parts.

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[2]The Economic Commission for Europe has prepared a *Guide on Drawing Up International Contracts for Services Relating to Maintenance, Repair and Operation of Industrial and Other Works*, which may, *mutatis mutandis*, assist parties in drafting a separate contract or contracts dealing with maintenance and repair of the facility after its transfer to the contracting authority (ECE/TRADE/154).

(d) Repairs

58. It is in the contracting authority's interest to enter into contractual arrangements that will ensure that the facility will be repaired expeditiously in the event of a breakdown. In many cases, the concessionaire may be better qualified than a third person to effect repairs. In addition, if the project agreement prevents the contracting authority from disclosing to third persons the technology supplied by the concessionaire, this may limit the selection of third persons to effect repairs to those who provide assurances regarding non-disclosure of the concessionaire's technology that are acceptable to the concessionaire. On the other hand, if major items of equipment have been manufactured for the concessionaire by suppliers, the contracting authority may find it preferable to enter into independent contracts for repair with the suppliers, as they may be better qualified to repair the items. In defining the nature and duration of repair obligations imposed on the concessionaire, if any, it is advisable to do so clearly and to distinguish them from obligations assumed by the concessionaire under quality guarantees to remedy defects in the facility.

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PRIVATELY FINANCED INFRASTRUCTURE PROJECTS

Draft chapters of a legislative guide on privately financed infrastructure projects

Report of the Secretary-General

Addendum

Chapter VII. GOVERNING LAW

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LEGISLATIVE RECOMMENDATIONS

1. The law governing the project agreement (see paras. 4 and 5)

1. The host country may wish to enact provisions that indicate, as appropriate, the statutory or regulatory texts that govern the project agreement and those whose application is excluded.

2. The law governing contracts entered into by the concessionaire (see paras. 6-8)

2. The host country may wish to consider adopting legislative provisions recognizing the freedom of the concessionaire and its lenders, insurers and other contracting partners to choose the applicable law to govern their contractual relations.

3. Other relevant areas of legislation (see paras. 9-58)

3. The host country may wish to consider reviewing and, as appropriate, revising rules of law in other areas relevant to privately financed infrastructure projects (investment promotion and protection, property law, rules and procedures on expropriation, intellectual property law, security interests, company law, accounting practices, contract law, rules on government contracts and administrative law, insolvency law, tax law, environmental and consumer protection law and anti-corruption measures).

NOTES ON THE LEGISLATIVE RECOMMENDATIONS

A. General remarks

1. The stage of development of the relevant laws of the host country, the stability of its legal system and the adequacy of remedies available to private parties are essential elements of the overall legal framework for privately financed infrastructure projects. By reviewing and, as appropriate, improving its laws in those areas of immediate relevance for privately financed infrastructure projects, the host country will make an important contribution to securing a hospitable climate for private sector investment in infrastructure. Greater legal certainty and a favourable legal framework will translate into a better assessment of country risks by lenders and project sponsors. This will have a positive influence on the cost of mobilizing private capital and reduce the need for governmental support or guarantees (see chap. II, "Government support", ___).

2. Section B deals with choice of the law or laws governing the project agreement and other contracts entered into by the concessionaire during the life of the project (see paras. 3-8). Section C points out a few selected aspects of the laws of the host country that, without necessarily dealing directly with privately financed infrastructure projects, may have an impact on their implementation (see paras. 9-58). Section D indicates the possible relevance of a few international agreements for the implementation of privately financed infrastructure projects in the host country (see paras. 59-63).

B. The law governing the project agreement and related contracts

3. Statutory provisions governing the project agreement are not frequently found in domestic legislation on privately financed infrastructure projects. Where they do appear, they usually provide for the application of the laws of the host country by a general reference to domestic law or by mentioning special statutory or regulatory texts that apply to the project agreement. In some legal systems there may be an implied submission to the laws of the host country, even in the absence of a statutory provision to that effect. Statutory provisions concerning the law governing contracts entered into by the concessionaire appear even more rarely in domestic legislation, as discussed below.

1. The law governing the project agreement

4. The law governing the project agreement would typically include the rules contained in laws and regulations of the host country related directly to privately financed infrastructure projects, where specific legislation on the matter exists. The main elements of those laws have been considered in previous chapters of the *Guide*. As noted earlier (see chap. I, "General legislative considerations", ___), in some countries the project agreement may be subject to administrative law, while in others the project agreement may be governed by private law (see also paras. 38-41). The governing law would also include legal rules of other fields of law that apply to the various issues that arise during the execution of an infrastructure project (see paras. 9-58). Some of those rules may be of an administrative or other public law nature and their application in the host country may be mandatory, such as environmental protection measures and health and labour conditions. Some domestic laws expressly identify the matters that are subject to rules of mandatory application. However, a number of issues arising out of the project agreement or the operation of the facility may not be the subject of mandatory rules of a public law nature. This is typically the case of most contractual issues arising under the project agreement (e.g. formation, validity and breach of contract, including liability and compensation for breach of contract and wrongful termination).

5. Even though it would not be possible to list exhaustively in the law all the statutes or regulations of direct or subsidiary relevance for privately financed infrastructure projects, for purposes of clarity it may be advisable

to indicate in the law those statutory and regulatory texts which are directly applicable to the execution of privately financed infrastructure projects and, as appropriate, those whose application is excluded.

2. The law governing contracts entered into by the concessionaire

6. It is common for the concessionaire and its contractors to choose a law that is familiar to them and that in their view adequately governs the issues addressed in their contracts. Depending upon the type of contract, different issues concerning the governing-law clause will arise. For example, as regards the financing agreements that the concessionaire enters into, it is most likely that the lenders will require that the governing law be that of a jurisdiction with an established set of laws regarding international financial transactions. Equipment supply and other contracts may be entered into with foreign companies and the parties may wish to choose a law known to them as providing, for example, an adequate warranty regime for equipment failure or non-conformity of equipment. In turn, the concessionaire may agree to the application of the laws of the host country in connection with contracts entered into with local customers.

7. Domestic laws seldom contain provisions concerning the law governing the contracts entered into by the concessionaire. In a few countries, the law limits the application of foreign law to issues that are not regulated by domestic law or subjects choices of foreign law to approval by the contracting authority. However, most countries have found no compelling reason for making provisions concerning the law governing the contracts between the concessionaire and its contractors and have preferred to leave the question to a choice-of-law clause in their contracts or to the applicable conflict-of-laws rules.

8. In some cases, provisions have been included in domestic legislation for the purpose of clarifying, as appropriate, that the contracts entered into between the concessionaire and its contractors are governed by private law and that the contractors are not agents of the contracting authority. A provision of that type may in some countries have a number of practical consequences, such as no subsidiary liability of the contracting authority for the acts of the subcontractors or no obligation on the part of the responsible public entity to pay worker's compensation for work-related illness, injury or death to the subcontractors' employees.

C. Other relevant areas of legislation

9. In addition to issues pertaining to legislation directed specifically towards privately financed infrastructure projects, a favourable legal framework also requires supportive provisions in other areas of legislation. Private investment in infrastructure will be encouraged by the existence of legislation that promotes and protects private investment in economic activities. The following paragraphs pinpoint only a few selected aspects of other fields of law that may have an impact on the implementation of infrastructure projects. The existence of adequate legal provisions in those other fields may facilitate a number of transactions necessary to carrying out infrastructure projects and help to reduce the perceived legal risk of investment in the host country.

1. Promotion and protection of investment

10. One matter of particular concern for the project consortia and the lenders is the degree of protection afforded to investment in the host country. The confidence of investors in the host country may be fostered, for example, by protection from nationalization or dispossession without judicial review and appropriate compensation in accordance with international law. Project sponsors participating in project consortia will also be concerned about their ability, *inter alia*, to bring to the country without unreasonable restriction the qualified personnel required to work with the project, to import needed goods and equipment, to have access to foreign exchange as needed and to transfer abroad or repatriate their profits or sums needed to repay loans that the company has entered into for the purpose of the infrastructure project. In addition to specific guarantees that may be provided by the Government (see chap. II, "Government support", ___), legislation on promotion and

protection of investment may play an important role in connection with privately financed infrastructure projects. For countries that already have adequate investment protection legislation, it may be useful to consider expressly extending the protection provided in such legislation to private investment in infrastructure projects.

11. An increasing number of countries have entered into bilateral investment agreements that aim at facilitating and protecting the flow of investment between the contracting parties. Investment protection agreements usually contain provisions concerning the admission and treatment of foreign investment; transfer of capital between the contracting parties (e.g. payment of dividends abroad or repatriation of investment); availability of foreign exchange for transfer or repatriation of proceeds of investment; protection from expropriation and nationalization; and settlement of investment disputes. The existence of such an agreement between the host country and the originating country or countries of the project sponsors may play an important role in their decision to invest in the host country. Depending on its terms, such an agreement may reduce the need for assurances or guarantees by the Government geared to individual infrastructure projects.

2. Property law

12. It is desirable for the property laws of the host country to reflect acceptable modern standards, contain adequate provisions on the ownership and use of land and buildings, as well as movable and intangible property, and ensure the concessionaire's ability to purchase, sell, transfer and license the use of property, as appropriate. Constitutional provisions protecting property rights have been found to be important factors to foster private investment in many countries (see also chap. I, "General legislative considerations", ___).

13. Where the concessionaire owns the land on which the facility is built, it is important that the ownership of the land can be clearly and unequivocally established through adequate registration and publicity procedures. The concessionaire and lenders will need clear proof that ownership of the land will not be subject to dispute. They will therefore be reluctant to commit funds to the project if the laws of the host country do not provide adequate means for ascertaining ownership of the land.

14. It is also necessary to provide effective mechanisms for the enforcement of the property and possessory rights granted to the concessionaire against violation by third parties. Enforcement should also extend to easements and rights of way that may be needed by the concessionaire for providing and maintaining the relevant service (e.g. placing of poles and cables on private property to ensure the distribution of electricity) (see chap. IV, "The project agreement", ___).

3. Rules and procedures on expropriation

15. Where the host Government assumes responsibility for providing the land required for the implementation of the project, it may be either purchased from its owners or, if necessary, compulsorily acquired against the payment of adequate compensation by procedures referred to in the *Guide* as "expropriation" (see chap. IV, "The project agreement", ___). Many countries have legislation governing expropriation procedures and that legislation would probably apply to the compulsory acquisition of property required for privately financed infrastructure projects.

16. Expropriation proceedings often involve both administrative and judicial phases, which may be lengthy and complex. The host Government might thus wish to review existing provisions on expropriation for reasons of public interest with a view to assessing their adequacy to the needs of large infrastructure projects and to determining whether such provisions allow quick and cost-effective procedures, with due consideration of the rights of the owners. It is particularly important to enable the host Government to take possession of the property as early as possible, to the extent permitted by law, so as to avoid start-up delay and increased project costs

4. Intellectual property law

17. Privately financed infrastructure projects frequently involve the use of new or advanced technologies protected under patents or similar intellectual property rights. They may also involve the formulation and submission of original or innovative solutions, which may constitute the proponent's proprietary information under copyright protection. Therefore, private investors, national and foreign, bringing new or advanced technology into the host country or developing original solutions will need to be assured that their intellectual property rights will be protected and that they will be able to enforce those rights against infringements.

18. A legal framework for the protection of intellectual property may be provided by adherence to international agreements regarding the protection and registration of intellectual property rights. It would be desirable to strengthen the protection of intellectual property rights in line with such instruments as the Paris Convention for the Protection of Industrial Property of 1883.[1] The Convention applies to industrial property in the widest sense, including inventions, marks, industrial designs, utility models, trade names, geographical indications and the repression of unfair competition. The Convention provides that, as regards the protection of industrial property, each contracting State must grant national treatment. It also provides for the right of priority in the case of patents, marks and industrial designs and establishes a few common rules that all the contracting States must follow in relation to patents, marks, industrial designs, trade names, indications of source, unfair competition and national administrations. A framework for further international patent protection is provided under the Patent Cooperation Treaty of 1970, which makes it possible to seek patent protection for an invention simultaneously in each of a large number of countries by filing an international patent application.

19. Other important instruments providing international protection of industrial property rights are the Madrid Agreement Concerning the International Registration of Marks of 1891,[2] the Protocol Relating to the Madrid Agreement of 1989 and the Common Regulations under the Madrid Agreement and the Protocol Relating thereto of 1998. The Madrid Agreement provides for the international registration of marks (both trademarks and service marks) at the International Bureau of the World Intellectual Property Organization (WIPO). International registration of marks under the Madrid Agreement has effect in several countries, potentially in all the contracting States (except the country of origin). Furthermore, the Trademark Law Treaty of 1994 simplifies and harmonizes procedures for the application for registration of trademarks, changes after registration and renewal.

20. In the area of industrial designs, the Hague Agreement Concerning the International Deposit of Industrial Designs of 1925[3] provides for the international deposit of industrial designs at the International Bureau of WIPO. The international deposit has, in each of the contracting States designated by the applicant, the same effect as if all the formalities required by the domestic law for the grant of protection had been complied with by the applicant and as if all administrative acts required to that end had been accomplished by the office of that country.

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[1] As revised at Brussels on 14 December 1900, at Washington, D.C., on 2 June 1911, at The Hague on 6 November 1925, at London on 2 June 1934, at Lisbon on 31 October 1958 and at Stockholm on 14 July 1967 and as amended on 2 October 1979.

[2] As revised at Brussels on 14 December 1900, at Washington, D.C., on 2 June 1911, at The Hague on 6 November 1925, at London on 2 June 1934, at Nice on 15 June 1957 and at Stockholm on 14 July 1967.

[3] With the Additional Act of Monaco of 1961, the Complementary Act of Stockholm of 1967 as amended on 28 September 1979 and the Regulations Under the Hague Agreement Concerning the International Deposit of Industrial Designs of 1998.

21. The above instruments are complemented by treaties establishing international classifications, such as the Strasbourg Agreement Concerning the International Patent Classification of 1971, the Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks of 1957, the Vienna Agreement Establishing an International Classification of the Figurative Elements of Marks of 1973 and the Locarno Agreement Establishing an International Classification for Industrial Designs of 1968.

5. Security interests

22. Crucial to the success of privately financed infrastructure projects is a domestic legal regime that offers lenders reliable security. The types of asset that might be encumbered and the types of security interest that might be created will vary from one system of law to the next. Because of the significant differences between legal systems regarding the law of security interests, the *Guide* does not discuss in detail the technicalities of the requisite legislation and the following paragraphs provide only a general outline of the main elements of a modern regime for secured transactions.

23. In some legal systems, security interests can be created in virtually all kinds of assets, including intellectual property, whereas in other systems security interests can only be created in a limited category of assets, such as land and buildings. In some countries, security interests can be created over assets that do not yet exist (future assets) and security may be taken over all of a company's assets, while allowing the company to continue to deal with those assets in the ordinary course of business. Some legal systems provide for a non-possessory security interest, so that security can be taken over assets without taking actual possession of the assets; in other systems, as regards those assets which are not subject to a title registration system, security may only be taken by physical possession or constructive possession. Under some systems, enforcement of the security interest can be undertaken without court involvement, whereas in other systems it may only be enforced through court procedures. Some countries provide enforcement remedies that not only include sale of the asset, but also enable the secured lender to operate the asset either by taking possession or appointing a receiver; in other countries, judicial sale may be the primary enforcement mechanism. Under some systems, certain types of security will rank ahead of preferential creditors, whereas in others the preferential creditors rank ahead of all types of security. In some countries, creation of a security interest is cost-efficient, with minimal fees and duties payable, whereas in other countries it can be costly. In some countries, the value of the amount of security taken may be unlimited, while in others the value of security cannot be excessive in comparison with the debt owed. Some legal systems impose obligations on the secured lender to the debtor and to third parties on enforcement of the security, such as the obligation to sell the asset at fair market value.

24. The type and extent of security offered by the concessionaire or its shareholders will play a central role in the contractual arrangements for the financing of infrastructure projects. The security arrangements may be complex and consist of a variety of forms of security, including fixed security over physical assets of the concessionaire (e.g. mortgages or charges), pledges of shares of the concessionaire and assignment of intangible assets (receivables) of the project. While the loan agreements are usually subject to the governing law chosen by the parties, the laws of the host country will in most cases determine the type of security that can be enforced against assets located in the host country and the remedies available. Differences in the type of security or limitations in the remedies available under the laws of the host country may be a cause of concern to potential lenders. It is therefore important to ensure that domestic laws provide adequate legal protection to secured creditors and do not hinder the ability of the parties to establish appropriate security arrangements.

25. Basic legal protection may include provisions ensuring that fixed security (e.g. a mortgage) is a registrable interest and that, once such security is registered in the central register of title or other public register, any purchaser of the property to which the security attaches should take the property subject to such security. This may be difficult, since in many countries no central registers of title exist. Furthermore, security should be enforceable against third parties, have the nature of a property right and not a mere obligation, and should entitle the person receiving security to a sale, in enforcement proceedings, of the assets taken as security. Secured creditors should enjoy preference to unsecured creditors in insolvency proceedings.

26. Another important aspect concerns the flexibility given to the parties to define the assets that are given as security. In some legal systems, broad freedom is given to the parties in the definition of assets that may be given as security. In some legal systems, it is possible to create security that covers all the assets of an enterprise, making it possible to sell the enterprise as a going concern, which may enable an enterprise in financial difficulties to be rescued while increasing the recovery of the secured creditor. Other legal systems, however, allow only the creation of security that attaches to specific assets and do not recognize security covering the entirety of the debtor's assets. There may also be limitations on the debtor's ability to trade in goods given as security. The existence of limitations and restrictions of this type makes it difficult or even impossible for the debtor to create security over generically described assets or over assets traded in the ordinary course of its business.

27. Given the long-term nature of privately financed infrastructure projects, the parties may wish to be able to define the assets that are given as security specifically or generally. They may also wish such security to cover present or future assets and assets that might change during the life of the security. It may be desirable to review existing provisions on security interests with a view to including provisions enabling the parties to agree on suitable security arrangements.

28. As indicated earlier (see chap. IV, "The project agreement", ___), another form of security typically given in connection with certain privately financed infrastructure projects is an assignment to lenders of proceeds from contracts with customers of the concessionaire. Those proceeds may consist of the proceeds of a single contract (e.g. a power purchase commitment by a power distribution entity) or of a large number of individual transactions (e.g. monthly payment of gas or water bills). In most cases it would not be practical for the concessionaire to specify individually the receivables being assigned to the creditors. Therefore, assignment of receivables in project finance typically takes the form of a bulk assignment of future receivables. However, there may be considerable uncertainty in various legal systems with regard to the validity of the wholesale assignment of receivables and of future receivables.

29. Thus far, no comprehensive uniform regime or model for the development of domestic security laws has been developed by international intergovernmental bodies. Governments would be advised, however, to take account of various efforts being undertaken in different organizations.

30. A model for the development of modern legislation on security interests is offered in the Model Law on Secured Transactions, which was prepared by the European Bank for Reconstruction and Development (EBRD) to assist legislative reform efforts in central and eastern European countries. Besides general provisions on who can create and who can receive a security right and general rules concerning the secured debts and the charged property, the EBRD Model Law on Secured Transactions covers other matters, such as the creation of security rights, the interests of third parties, enforcement of security and registration proceedings. The solutions proposed in the EBRD Model Law are intended to achieve the objectives discussed in paragraphs 24-29 above.

[*Note for the Commission. Appropriate reference will be made to the draft convention on assignment in receivables financing presently being developed by the Working Group on International Contract Practices, as well as to other international initiatives (e.g. the draft model inter-American law on secured transactions currently being considered by the Organization of American States in the context of preparations for the Sixth Inter-American Conference on Private International Law and the UNIDROIT draft convention on international interests in mobile equipment.*]

6. Company law

31. In most projects involving the development of a new infrastructure, the project sponsors will establish the project entity as a separate legal entity in the host country (see chap. IV, "The project agreement", ___). It is recognized that the project entity may take various forms in different countries, which may not necessarily entail a corporation. As in most cases it is a corporate form that is selected, it is particularly important for the host country to have adequate company laws with modern provisions on essential matters such as establishment procedures, corporate governance, issuance of shares and their sale or transfer, accounting and financial statements and protection of minority shareholders. Furthermore, the recognition of the investors' ability to establish separate entities to serve as special-purpose vehicles for raising financing and disbursing funds may facilitate the closing of project finance transactions (see chap. IV, "The project agreement", ___).

32. Although various corporate forms may be used for incorporating project operators, a common characteristic is that the concessionaire's owners (or shareholders) will require that their liability be limited to the value of their shares in the company's capital. If it is intended that the concessionaire will offer shares to the public, limited liability will be necessary, as the prospective investors will usually only purchase those shares for their investment value and will not be closely involved in the operation of the concessionaire. It is therefore important that the laws of the host country provide adequately for the limitation of liability of shareholders. Furthermore, adequate provisions governing the issuance of bonds, debentures or other securities by commercial companies will enable the concessionaire to obtain funds from investors on the security market, thus facilitating the financing of certain infrastructure projects.

33. Legislation should establish the responsibilities of directors and administrators of the concessionaire, including the basis for criminal responsibility. It can also set out provisions for the protection of third parties affected by any breach of corporate responsibility. Modern company laws often contain specific provisions regulating the conduct of managers so as to prevent conflicts of interest. Provisions of this type require that managers act in good faith in the best interest of the company and do not use their position to foster their own or any other person's financial interests to the detriment of the company. Provisions intended to curb conflicts of interest in corporate management may be particularly relevant in connection with infrastructure projects, where the concessionaire may wish to engage its own shareholders, at some stage of the project, to perform work or provide services in connection with it (see chap. V, "Infrastructure development and operation", ___).

34. It is important for the law to regulate adequately the decision-making process both for meetings of the shareholders and meetings of management organs of the company (e.g. the board of directors or supervisory board). Protection of shareholders' rights and, in particular, protection for minority shareholders from abuse by controlling or majority shareholders are important elements of modern company laws. Mechanisms for the settlement of disputes among shareholders are also critical. It is useful to recognize the right of the shareholders to regulate a number of additional matters concerning the management of the concessionaire through agreements among themselves or through management contracts with the directors of the concessionaire.

7. Accounting practices

35. In several countries, companies are required by law to follow generally accepted accounting practices. Among the reasons for this is that the adoption of standard accounting practices is a measure taken in many countries to achieve uniformity in the valuation of businesses. The use of modern and internationally acceptable accounting practices may be instrumental in ensuring the marketability of bonds and other security issued by the concessionaire for the purpose of raising funds in international financial markets. In connection with the selection of the concessionaire, the use of standard accounting practices may also facilitate the task of evaluating the financial standing of bidders in order to determine whether they meet the pre-selection criteria required by the contracting authority (see chap. III, "Selection of the concessionaire", ___). Standard accounting practices are also essential for carrying out audits of the profits of companies, which may be required for the application of tariff structures and the verification of compliance by the regulatory body (see chap. V, "Infrastructure development and operation", ___).

8. Contract law

36. The contract laws of the host country play an important role in connection with contracts entered into by the concessionaire with subcontractors, suppliers and other parties. The domestic law on commercial contracts should provide adequate solutions to the needs of the concessionaire and its contracting parties, including flexibility in devising the contracts needed for the construction and operation of the infrastructure facility. Apart from some essential elements of adequate contract law, such as general recognition of party autonomy, judicial enforceability of contract obligations and adequate remedies for breach of contract, the laws of the host country may create a favourable environment for privately financed infrastructure projects by facilitating contractual arrangements likely to be used in those projects. An adequate set of rules of private international law is also important, given the likelihood that contracts entered into by the concessionaire will include some international element.

37. Where new infrastructure is to be built, the concessionaire may need to import large quantities of supplies and equipment. Greater legal certainty for such transactions will be ensured if the laws of the host country contain provisions specially adapted to international sales contracts. A particularly suitable legal framework may be provided by adherence to the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980)[4] or other international instruments dealing with specific contracts, such as the UNIDROIT Convention on International Financial Leasing (Ottawa, 1988),[5] drawn up by the International Institute for the Unification of Private Law (UNIDROIT).

9. Rules on government contracts and administrative law

38. In many legal systems belonging to or influenced by the tradition of civil law, the provision of public services may be governed by a body of law known as "administrative law", which regulates a wide range of governmental functions. Such systems operate under the principle that the Government can exercise its powers and functions either by means of an administrative act or an administrative contract. It is also generally understood that, alternatively, the Government may enter into a private contract, subject to the law governing private commercial contracts. The differences between the two types of contract may be significant.

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[4] *Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-1 April 1980* (United Nations publication, Sales No. E.82.V.5), part I.

[5] *Acts and Proceedings of the Diplomatic Conference for the adoption of the draft Unidroit Conventions on International Factoring and International Financial Leasing, Ottawa, 9-28 May 1988*, vol. I.

39. Under the concept of the administrative contract, the freedom and autonomy the parties to a private contract enjoy are subordinate to the public interest. In some legal systems, the Government has the right to terminate administrative contracts (see chap. VI, "End of project term, extension and termination", ___) or to modify their scope and terms, for reasons of public interest, usually subject to compensation for loss sustained by the private contracting party (see chap. V, "Infrastructure development and operation", ___). Additional rights might include extensive monitoring and inspection rights, as well as the right to impose sanctions on the private operator for failure to perform. This is often balanced by the requirement that other changes may be made to the contract as may be necessary to restore the original financial equilibrium between the parties and to preserve the contract's general value for the private contracting party (see chap. V, "Infrastructure development and operation", ___). In some legal systems, disputes arising out of government contracts are subject to the exclusive jurisdiction of special tribunals dealing solely with administrative matters, which in some countries are separate from the judicial system (see chap. VIII, "Settlement of disputes", ___).

40. The existence of a special legal regime applicable to infrastructure operators and public service providers is not limited to the legal systems referred to above. Although in other legal systems influenced by the tradition of common law no such categorical distinction is made between administrative contracts and private contracts, similar consequences may be achieved by different means. While under such systems of law it is frequently held that the rule of law is best maintained by subjecting the Government to ordinary private law, it is generally recognized that the administration cannot by contract fetter the exercise of its sovereign functions. It cannot hamper its future executive authority in the performance of those governmental functions which affect the public interest. Under the doctrine of sovereign acts, which is upheld in some common law jurisdictions, the Government as contractor is excused from the performance of its contracts if the Government as sovereign enacts laws, regulations or orders in the public interest that prevent that performance. Thus, the law may permit a government agency to interfere with vested contractual rights. Usually such action is limited so that the changes cannot be of such magnitude that the other party could not fairly adapt to them. In those circumstances, the private party is ordinarily entitled to some sort of compensation or equitable adjustment (see chap. V, "Infrastructure development and operation", ___). In anticipation of such possibilities, in some countries a standard "changes" clause is included in a governmental contract that enables the Government to alter the terms on a unilateral basis or that provides for changes as a result of an intervening sovereign act.

41. Special prerogatives for governmental agencies are justified in those legal systems by reasons of public interest. It is however recognized that special governmental prerogatives, in particular the power to alter the terms of contracts unilaterally, may, if improperly used, adversely affect the vested rights of government contractors. For this reason, countries with a well established tradition of private participation in infrastructure projects have developed a series of control mechanisms and remedies to protect government contractors against arbitrary or improper acts by government agencies, such as access to impartial dispute settlement bodies and full compensation schemes for governmental wrongdoing. Where protection of this nature is not afforded, rules of law providing government agencies with special prerogatives may be regarded by potential investors as an imponderable risk, which may discourage them from investing in particular jurisdictions. For this reason, some countries have reviewed their legislation on government contracts so as to provide the degree of protection needed to foster private investment and remove those provisions which gave rise to concern about the long-term contractual stability required for infrastructure projects.

10. Insolvency law

42. The insolvency of an infrastructure operator or public service provider raises a number of issues that have led some countries to establish special rules to deal with such situations, including rules that enable the host Government to take the measures required to ensure the continuity of the project (see chap. VI, "End of project term, extension and termination", ___). The continuity in the provision of the service may be achieved by means of a legal framework that allows for the rescue of economically viable enterprises facing financial difficulties,

such as reorganization and similar proceedings. In the event that bankruptcy proceedings become inevitable, the secured lenders will be specially concerned about provisions concerning secured claims, in particular as to whether secured creditors may foreclose on the security despite the opening of bankruptcy proceedings, whether secured creditors are given priority for payments made with the proceeds of the security and how claims of secured creditors are ranked. As noted earlier, a substantial portion of the concessionaire's debt takes the form of "senior" loans, with the lenders requiring precedence of payment over payment of the subordinated debt of the concessionaire (see "Introduction and background information on privately financed infrastructure projects", ___). The extent to which the lenders will be able to enforce such subordination arrangements will depend on the rules and provisions of the laws of the country that govern the ranking of creditors in insolvency proceedings. The legal recognition of party autonomy on the establishment of contractual subordination of different classes of loans may facilitate the financing of infrastructure projects.

43. Among the issues that the legislation should address are the following: the question of the ranking of creditors; the priority between the insolvency administrator and creditors; legal mechanisms for reorganization of the insolvent debtor; special rules designed to ensure the continuity of the public service in case of insolvency of the concessionaire; and provisions on avoidance of transactions entered into by the debtor shortly before the opening of the insolvency proceedings.

44. The insolvency of a concessionaire is likely to involve creditors from more than one country or affect assets located in more than one country. It may therefore be desirable for the host country to have provisions in place that facilitate judicial cooperation, court access for foreign insolvency administrators and recognition of foreign insolvency proceedings. A suitable model that may be used by countries wishing to adopt legislation for that purpose is provided in the UNCITRAL Model Law on Cross-Border Insolvency.

11. Tax law

45. In addition to possible tax incentives that may be generally available in the host country or that may be specially granted to privately financed infrastructure projects (see chap. II, "Government support", ___), the general taxation regime of the host country plays a significant role in the investment decisions of private companies. Beyond an assessment of the impact of taxation in the project cost and the expected margin of profit, private investors consider questions such as the overall transparency of the domestic taxation system, the degree of discretion exercised by taxation authorities, the clarity of guidelines and instructions issued to taxpayers and the objectivity of criteria used to calculate tax liabilities. This may be a complex matter, in particular in those countries where the authority to establish or increase taxes or to enforce tax legislation has been decentralized.

46. The stability of the tax regime is crucial to the success of privately financed infrastructure projects. Many projects are highly leveraged and require a predictable cash flow. Unanticipated changes in the taxes that reduce that cash flow can have serious consequences for the project. All potential tax implications should be readily assessable throughout the life of the project. In some countries, the Government is authorized to enter into agreements with the investors for the purpose of guaranteeing the stability of the tax regime applicable to the project. However, the Government may be restrained, by constitutional law or for political reasons, from providing this type of guarantee, in which case the parties may agree on compensation or contractual revision mechanisms for dealing with cost increases due to tax changes (see also chap. V, "Infrastructure development and operation", ___).

47. Most national tax regimes fall into one of three general categories. One approach is worldwide taxation with credits, in which all income earned anywhere is taxed in the home country and double taxation is avoided through the use of a foreign tax credit system; home country taxes are reduced by the amount of foreign taxes already paid. If this approach is used by an investor's home country, the investor's tax liability can be no less than it would be at home. Under a different taxation approach, the foreign income that has already been subject

to foreign tax is exempt from taxation by the home country of the investor. Under a territorial approach, foreign income is exempt from home country taxation altogether. Investors in home countries that use the latter two systems of taxation would benefit from tax holidays and lower tax rates in the host country, but such tax relief would offer no incentive to an investor located in a tax haven.

48. The parties involved in the project may have different concerns over potential tax liability. Investors are usually concerned over the taxation of profits earned in the host country, taxation on payments made to contractors, suppliers, investors and lenders, and tax treatment of any capital gains (or losses) when the concessionaire is wound up. Investors may find that payments used to reduce taxes under their home country regime (such as payments for interest on borrowed funds, investigation costs, bidding costs and foreign exchange losses) may not be available in the host country, or vice versa. Since foreign tax credits are only allowed for foreign income taxes, investors need to ensure that any income tax paid in the host country satisfies the definition of income tax of their own country's taxing authority. Similarly, the concessionaire in the host country may be treated for tax purposes as a different type of entity in the home country. In projects where the assets become the property of the Government, this may preclude deductions for depreciation under the laws of the home country.

49. One particular problem of privately financed infrastructure projects involving foreign investment is the possibility that foreign companies participating in a project consortium may be exposed to double taxation, that is, taxation of profits, royalties and interests in their own home countries as well as in the host country. The timing of tax payments and requirements to pay withholding taxes can also pose problems. A number of countries have entered into bilateral agreements to eliminate or at least reduce the negative effects of double taxation and the existence of such agreements between the host country and the home countries of the project sponsors often plays a role in their tax considerations.

50. Ultimately, it is the cumulative effect of all taxes combined that needs to be taken into consideration. For example, there may be taxes imposed by more than one level of taxing authority; in addition to taxation by the national Government, the concessionaire may also face municipal or provincial taxes. There may also be certain levies other than income taxes, which are often are due and payable before the concessionaire has earned any revenues. These include sales taxes, sometimes referred to as "turnover taxes", value-added taxes, property taxes, stamp duties and import duties. Sometimes special provisions can be made to offer relief from these payments as well.

12. Environmental protection

51. Environmental protection encompasses a wide variety of issues, ranging from handling of wastes and hazardous substances to relocation of persons displaced by large land-use projects. It is widely recognized that environmental protection is a critical prerequisite to sustainable development. Adhering to treaties relating to the protection of the environment may help to strengthen the international regime of environmental protection. A large number of international instruments have been developed in the past decades to establish common international standards. These include the following: Agenda 21 and the Rio Declaration on Environment and Development, adopted by the United Nations Conference on Environment and Development in 1992; the World Charter for Nature (General Assembly resolution 37/7 of 28 October 1982); the Basel Convention on the Control of Transboundary Movement of Hazardous Wastes and Their Disposal of 1989; the Convention on Environmental Impact Assessment in a Transboundary Context of 1991; and the Convention on the Protection and Use of Transboundary Watercourses and International Lakes of 1992.

52. Environmental protection legislation is likely to have a direct impact on the implementation of infrastructure projects at various levels and environmental matters are among the most frequent causes of disputes. Environmental protection laws may include various requirements, such as the consent by various

environmental authorities, evidence of no outstanding environmental liability, assurances that environmental standards will be maintained, commitments to remedy environmental damage and notification requirements. These laws often require prior authorization for the exercise of a number of business activities, which may be particularly stringent for some types of infrastructure (e.g. waste water treatment, waste collection, the coal-fired power sector, power transmission, roads and railways). Authorizations and licences are often required for undertaking construction work or for installing certain physical structures. The denial of an environmental licence may constitute an unsurmountable obstacle to the execution of the whole project.

53. It is therefore advisable to ensure the highest possible degree of clarity in provisions concerning the tests that may be applied by the environmental authorities, the documentary and other requirements to be met by the applicants, the conditions under which licences are to be issued and the circumstances that justify the denial or withdrawal of a licence. Particularly important are provisions that guarantee the applicant's access to expeditious appeals procedures and judicial recourse, as appropriate. It may also be advisable to ascertain to the extent possible, prior to the final award of the project, whether the conditions for obtaining such a licence are met. In some countries, special government agencies or advocacy groups may have the right to institute legal proceedings to seek to prevent environmental damage, which may include the right to seek the withdrawal of a licence deemed to be inconsistent with applicable environmental standards. In some of those countries, it has been found useful to involve representatives of the public in the proceedings that lead to the issuance of environmental licences. The legislation may also establish the range of penalties that may be imposed and specify the parties that may be held responsible for the damage.

54. Further issues under the host country's environmental laws may arise when the concessionaire takes over an existing infrastructure facility, in particular where the question of responsibility for environmental damage caused by government-owned industry prior to privatization has not been clarified. Private investors may be reluctant to take over an existing infrastructure or purchase shares in public utilities that may be called upon in the future to compensate for or remedy environmental damage caused by the enterprise before it was privatized. It may therefore be advisable to establish mechanisms for compensating the private investors for liability incurred as a result of environmental damage caused during the period of government operation.

13. Consumer protection laws

55. A number of countries have special rules of law on consumer protection. Consumer protection laws vary greatly from country to country, both in the way they are organized and in their substance. Nevertheless, consumer protection laws often include provisions such as favourable time limits for asserting claims and enforcing contractual rights; special rules for the interpretation of contracts whose terms are not usually negotiated with the consumer (sometimes referred to as "adhesion contracts"); extended warranties in favour of consumers; special termination rights; access to simplified dispute settlement instances; or other protective measures. From the concessionaire's perspective, it is important to consider whether the host country's laws on consumer protection may limit or hinder the concessionaire's ability to enforce, for instance, its right to obtain payment for the services provided, to adjust prices or to discontinue services to customers who fail to pay for the services.

14. Anti-corruption measures

56. The investment and business environment in the host country may also be enhanced by measures to fight corruption in the administration of government contracts. The rules covering the functioning of contracting authorities and the monitoring of public contracts should be reviewed and, where such rules do not exist, appropriate legislation and regulations should be developed and adopted to ensure the required degree of transparency and integrity. Simplicity and consistency, coupled with the elimination of unnecessary procedures

that prolong the administrative procedures or make them cumbersome, are additional elements to be taken into consideration in this context.

57. It is furthermore particularly important for the host country to take effective and concrete action to combat all forms of corruption, bribery and related illicit practices, in particular to pursue effective enforcement of existing laws prohibiting bribery.

58. The enactment of laws that incorporate international agreements and standards on integrity in the conduct of public business may represent a significant step in that direction. Important standards are contained in two resolutions of the United Nations General Assembly: resolution 51/59 of 12 December 1996, by which the Assembly adopted the International Code of Conduct for Public Officials, and resolution 51/191 of 16 December 1996, by which it adopted the United Nations Declaration against Corruption and Bribery in International Commercial Transactions. Other important instruments include the Inter-American Convention against Corruption, adopted by the Organization of American States at the Specialized Conference for Consideration of the Draft Inter-American Convention against Corruption, held in Caracas in 1996, and the Convention on Combating Bribery of Foreign Public Officials in International Business Transaction of 1997, which was negotiated under the auspices of the Organisation for Economic Cooperation and Development.

D. International agreements

59. In addition to the internal legislation of the host country, privately financed infrastructure projects may be affected by international agreements entered into by the host country. The implications of certain international agreements is discussed briefly below.

1. Membership in multilateral financial institutions

60. Membership in multilateral financial institutions such as the World Bank, the International Development Association, the International Finance Corporation, the Multilateral Investment Guarantee Agency and the regional development banks may have a direct impact on privately financed infrastructure projects in various ways. Firstly, the host country's membership in those institutions is typically a requirement in order for projects in the host country to receive financing and guarantees provided by those institutions. Secondly, the rules on financing and guarantee instruments provided by those institutions typically contain a variety of terms and conditions of direct relevance for the terms of the project agreement and the loan agreements negotiated by the concessionaire (e.g. clause of negative pledge of public assets and provision of counter-guarantees in favour of the multilateral financial institution). Lastly, multilateral financial institutions usually follow a number of policy objectives whose implementation they seek to ensure in connection with projects supported by them (e.g. adherence to internationally acceptable environmental standards; long-term sustainability of the project beyond the initial concession period; transparency and integrity in the selection of the concessionaire and the disbursement of their loans).

2. General agreements on trade facilitation and promotion

61. A number of multilateral agreements have been negotiated to promote free trade at the global level. The most notable of those agreements have been negotiated under the auspices of the General Agreement on Tariffs and Trade and later the World Trade Organization (WTO). Those agreements may contain general provisions on trade promotion and facilitation of trade in goods (e.g. a most-favoured-nation clause, prohibition of the use of quantitative restrictions and other discriminatory trade barriers) and on the promotion of fair trade practices (e.g. prohibition of dumping and limitations on the use of subsidies). Some specific agreements are aimed at the removal of barriers for the provision of services by foreigners in the contracting States or promoting transparency and eliminating discrimination of suppliers in public procurement. Those agreements may be

relevant for national legislation on privately financed infrastructure projects that contemplates restrictions on the participation of foreign companies in infrastructure projects or establishes preferences for national entities or for the procurement of supplies on the local market.

3. International agreements on specific industries

62. In the context of the negotiations on basic telecommunications concluded as part of the General Agreement on Trade in Services (GATS), a number of States members of WTO representing most of the world market for telecommunication services have made specific commitments to facilitate trade in telecommunication services. It should be noted that all WTO member States (even those which have not made specific telecommunication commitments) are bound by the general GATS rules on services, including specific requirements dealing with most-favoured-nation treatment, transparency, regulation, monopolies and business practices. The WTO telecommunication agreement adds sector- and country-specific commitments to the overall GATS agreement. Typical commitments cover the opening of various segments of the market, including voice telephony, data transmission and enhanced services, to competition and foreign investment. Legislators of current or prospective WTO member States should thus ensure that the country's telecommunication laws are consistent with the GATS agreement and their specific telecommunication commitments.

63. Another important sector-specific agreement at the international level is the Energy Charter Treaty, concluded at Lisbon on 17 December 1994 and in force since 16 April 1998, which has been enacted to promote long-term cooperation in the energy field. The Treaty provides for various commercial measures such as the development of open and competitive markets for energy materials and products and the facilitation of transit and access to and transfer of energy technology. Furthermore, the Treaty aims at avoiding market distortions and barriers to economic activity in the energy sector and promotes the opening of capital markets to encourage the flow of capital in order to finance trade in materials and products. The Treaty also contains regulations about investment promotion and protection: equitable conditions for investors, monetary transfers related to investments, compensation for losses due to war, civil disturbance or other similar events and compensation for expropriation.

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PRIVATELY FINANCED INFRASTRUCTURE PROJECTS

Draft chapters of a legislative guide on privately financed infrastructure projects

Report of the Secretary-General

Addendum

Chapter VIII. SETTLEMENT OF DISPUTES

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LEGISLATIVE RECOMMENDATIONS

Disputes between the contracting authority and the concessionaire (see paras. 4-64)

(1) The host country may wish to consider:

(a) Reviewing and, as appropriate, removing unnecessary statutory limitations to the contracting authority's freedom to agree to dispute settlement mechanisms regarded by the parties as suited to the needs of the project;

(b) Reviewing its legislation on the question of sovereign immunity and indicate the extent to which the contracting authority may or may not raise a plea of sovereign immunity, both as a bar to the commencement of arbitral or judicial proceedings as well as a defense against enforcement of the award or judgement.

Settlement of commercial disputes (see paras. 65-76)

(2) The host country may wish to make provisions recognizing the concessionaire's freedom to choose the appropriate mechanisms for settling commercial disputes among the project sponsors, or disputes between the concessionaire and its lenders, contractors, suppliers and other business partners.

Disputes involving other parties (see paras. 77-82)

(3) The host country may wish to consider the desirability of making available special simplified and efficient mechanisms (including arbitration and conciliation) for the settlement of disputes between the concessionaire and its consumers or users of the infrastructure facility.

(4) The host country may wish to adopt legislative provisions that:

(a) Establish transparent procedures whereby the concessionaire may request a review of regulatory decisions by an independent and impartial body;

(b) Set forth the grounds on which a request for review may be based and the availability of court review.

NOTES ON THE LEGISLATIVE RECOMMENDATIONS

A. General remarks

1. An important factor for the implementation of privately financed infrastructure projects is the legal framework in the host country for the settlement of disputes. Investors, contractors and lenders will be encouraged to participate in projects in countries where they have the confidence that any disputes arising out of contracts forming part of the project will be resolved fairly and efficiently. By the same token, efficient procedures for avoiding disputes or settling them expeditiously will facilitate the exercise of the contracting authority's monitoring functions and reduce the overall cost of the regulatory process.

2. Privately financed infrastructure projects typically require the establishment of a network of interrelated contractual relationships between different parties. Legislative solutions regarding the settlement of disputes arising in the context of these projects must take account of the diversity of relations, and in particular of the fact that the variety of contracts and parties involved may call for different dispute settlement methods depending on the type of contract and parties involved. The legislative considerations underlying any regulation of dispute settlement mechanisms would depend on the types of agreements and contracts and the characteristics of disputes that may arise therefrom. The various agreements and contracts may be divided into three broad categories:

(a) *Agreements between the project company and the contracting authority and other governmental agencies*. The central instrument in an infrastructure project is the project agreement between the host Government and the concessionaire. The project agreement is in many countries subject to a legal regime often referred to as "administrative law", while in other countries the agreement is in principle governed by the law of contract as supplemented by special provisions developed for Government contracts for the provision of public services. This regime may have implications for the dispute settlement mechanism that the parties to the project agreement may be able to agree upon;

(b) *Commercial contracts and agreements concerning the implementation of the project*. These contracts usually include at least the following: (i) Contracts between parties holding equity in the project company (e.g. shareholders' agreements, agreements regarding the provision of additional financing or arrangements regarding voting rights); (ii) Financing and related agreements, which involve, apart from the project company, parties such as commercial banks, governmental lending institutions, international lending institutions and export credit insurers; (iv) Construction contract or contracts between the project company and a contractor, which itself may be a consortium of contractors, equipment suppliers and providers of services; (v) Contract or contracts between the project company and the party who operates and maintains the project facility; and (vi) Contracts for the supply of goods and services needed for the operation and maintenance of the facility;

(c) *Contracts between the project company or the operating or maintenance company on the one hand and the users of the facility on the other*. These users may include, for example, a state owned utility company that purchases electricity or water from the project company so as to resell

it to the ultimate users; commercial companies, such as airlines or shipping lines contracting for the use of the airport or port; or individual persons paying for the use of a toll road.

3. The types of contracts mentioned above in (b) are generally considered commercial contracts to which, as regards disputes settlement clauses, general rules regarding commercial contracts are applicable. Governments wishing to establish a hospitable legal climate for privately financed infrastructure projects would be advised to review their laws with respect to these contracts so as to eliminate any uncertainty regarding the freedom of the parties to agree to dispute settlement mechanisms of their choice, as further discussed in section C (see paras. 65-66). However, in many countries special considerations apply to dispute settlement clauses regarding, firstly, the project agreement between the contracting authority and the project company, and, secondly, contracts between the project company (or the operating or maintenance company) for the sale of goods or services to the end-users of the facility, in particular if the purchasers are State entities or individual persons as consumers. These considerations are discussed below in sections B (see paras. 4-64) and D (see paras. 77-82).

B. Disputes between the contracting authority and the concessionaire

1. General remarks

4. Disputes that arise under the project agreement frequently present problems that do not often exist in disputes arising under other types of contracts. This is due to the complexity of infrastructure projects, the fact that they are to be performed over a long period of time and involve a high level of public interest and the fact that a number of enterprises may participate in the construction and in the operational phases. In addition, disputes under project agreements may concern highly technical matters connected with the construction processes, the technology incorporated in the works and the conditions for operating the facility. Disputes that arise under the project agreement must be settled speedily in order not to disrupt the construction of the facility or the provision of the relevant services. These considerations ought to be taken into account by the parties in determining the dispute settlement mechanisms to be provided in the project agreement.

5. The issue that most frequently gives rise to disputes under the project agreement is whether a party has failed to perform its contractual obligations and, if so, the legal consequences of its failure. However, other questions often arise for which it is advisable to provide an appropriate settlement mechanism in the project agreement. For example, the project agreement may provide for its terms to be changed or supplemented in certain circumstances. Questions may arise as to whether those circumstances have occurred and, if so, how the contractual terms should be changed or supplemented (see chap. V, "Infrastructure development and operation", ___). The project agreement may also provide for the contracting authority to give its consent to certain actions by the concessionaire. If the contracting authority improperly withholds its consent, the question may arise whether an arbitral tribunal or court can substitute its own consent for that of the withholding party. Questions may also arise whether interim measures should be taken pending the final settlement of the dispute.

6. Under some legal systems, courts and arbitrators are not competent to change or supplement contractual terms or to substitute their own consent for a consent improperly withheld by a party. Under other legal systems, courts and arbitrators may do so only if they are expressly so authorized by the parties. Under yet other legal systems, arbitrators may do so but courts may not. Where the law applicable to the contract or to the proceedings does not permit courts or arbitrators to change contractual terms, the parties may wish to provide other means of changing certain terms, when it is feasible to do so. For example, they may provide for the prices charged by the concessionaire to change automatically by means of an index clause under certain circumstances (see chap.V, "Infrastructure development and operation", ___). They may provide for other contractual terms to be changed or supplemented by means of procedures before a third party, such as a referee or a dispute review board (see paras. 21-29). Where courts or arbitrators do not have the power to substitute their consent for a consent improperly withheld by a party, the project agreement may provide that a party may withhold its consent only upon specified grounds, and that, in the absence of those grounds, the consent is deemed to be given. Courts or arbitrators would then have to decide only whether the specified grounds existed.

7. In general, it is desirable for the parties initially to attempt to settle their disputes through negotiation (see paras. 11-12). The parties could, if they so desired, continue to negotiate even after other means of dispute settlement had been initiated. In some cases in which the parties have referred a dispute to conciliation (see paras.13-20) and arbitral or judicial proceedings are thereafter initiated, they might still find it useful to continue with the conciliation. Also, disputes may arise under a project agreement that are not within the legal competence of courts or arbitral tribunals or that cannot conveniently be settled in arbitral or judicial proceedings (for example, disputes of a technical nature that need to be resolved more speedily than is possible in arbitral or judicial proceedings).

8. In practice, it has been found useful for disputes arising under project agreements to be settled by arbitration: a process by which parties refer disputes that might arise between them or that have already arisen for binding decision by one or more independent and impartial persons (arbitrators) selected by them (see paras. 30-59). In general, arbitral proceedings may be initiated only on the basis of an arbitration agreement. The arbitral award is usually enforceable in a manner similar to a court decision. In the absence of an arbitration agreement, disputes between the parties will have to be settled in judicial proceedings (see paras. 60-64).

9. In considering which method or methods of dispute settlement to provide in the project agreement, the parties should ascertain, in particular, the scope of the authority that may be exercised by judges, arbitrators, a referee or a dispute review board under the law applicable to the procedures. They should also consider the extent to which a decision of a referee or dispute review board, arbitral award or judicial decision is enforceable in the countries of the parties. The fact that the contracting authority is often an agency of the Government may also be a factor influencing the method of dispute settlement to be provided.

10. Parties to a complex and long-term contractual relationship such as a project agreement sometimes agree on composite dispute-settlement clauses designed to prevent, to the extent possible,

disputes from arising and to foster reaching agreed solutions and efficient dispute settlement methods, when disputes nevertheless arise. Such clauses typically provide for a sequential series of steps starting with an early warning to the other party of issues that may develop into a dispute unless the parties take action to prevent them. When a dispute does occur the parties are required to exchange information and to discuss the dispute with a view to identifying a resolution. If the parties are unable to resolve the dispute themselves, then either party may require participation of an independent and impartial conciliator to assist them to find an acceptable resolution. If the assistance of a conciliator is not requested, then either party may request the assistance of the previously agreed panel entrusted with dispute settlement powers. As to such a panel, it may be agreed that assistance will first be sought from the chairman of the panel; if the dispute cannot be so resolved, either party may submit the dispute to the full panel or the panel itself may decide to consider the dispute. Only if the steps previously mentioned do not lead to a resolution, either party may commence arbitration or court proceedings, as provided in the dispute settlement clause.

2. Negotiation

11. The most satisfactory method of settling disputes is usually by negotiation between the parties. An amicable settlement reached through negotiation may avoid disruption of the business relationship between the contracting authority and the concessionaire. In addition, it may save the parties the considerable cost and the generally greater amount of time normally required for the settlement of disputes by other means.

12. Even though the parties may wish to attempt to settle their disputes through negotiation before invoking other means of dispute settlement, it may not be desirable for the project agreement to prevent a party from initiating other means of settlement until a period of time allotted for negotiation has expired. Furthermore, if the project agreement provides that other dispute settlement proceedings may not be initiated during the negotiation period, it is advisable to permit a party to initiate other proceedings even before the expiry of that period in certain cases, e.g. where a party states in the course of negotiations that it is not prepared to negotiate any longer, or where the initiation of arbitral or judicial proceedings before the expiry of the negotiation period is needed in order to prevent the loss or prescription of a right. It is advisable for the project agreement to require a settlement reached through negotiation to be reduced to writing.

3. Conciliation

13. If the parties fail to settle a dispute through negotiation, but wish nevertheless to avoid arbitral or judicial proceedings, they may attempt to do so through a process in which a third person is assisting the parties to reach a settlement, often by proposing solutions for their consideration. "Conciliation" or "mediation" are among the expressions that are frequently used for such non-adversarial proceedings. Conciliation differs from negotiations between the parties in that a conciliation is conducted by a third independent and impartial person, whereas in settlement negotiations between the parties no such third independent and impartial person is involved. The difference between conciliation and arbitral or judicial proceedings is that conciliation is voluntary in that both parties participate in it only to the extent that, and as long as, they both so agree.

Sometimes, however, the parties are committed by agreement to strive for a settlement during a specified period of time after the commencement of conciliation proceedings or until an event such as a written statement refusing to settle and declaring the conciliation as terminated. A further difference is that a conciliation ends either in a settlement of the dispute or it ends unsuccessfully, whereas the arbitral tribunal or the court, if there is no settlement, imposes a binding decision on the parties. Conciliation is being increasingly practised in various parts of the world. In many countries a number of private and public bodies have been established offering conciliation services to interested parties.

14. Conciliation is non-adversarial and fosters an amicable atmosphere, which makes it more likely that the parties in dispute will preserve or reinstate a good business relationship between them than in arbitral or judicial proceedings. Conciliation may even improve a business relationship, since the negotiations in the conciliation proceedings, joint fact-finding and the ultimate agreement of the parties may go beyond the confines of the dispute that gave rise to the conciliation and may result in a modified contractual relationship that is better adapted to the commercial reality. Because conciliation makes it possible to prescind with certain formalities that must be observed in arbitral or judicial proceedings, conciliation proceedings are likely to be more speedy and inexpensive than arbitral or judicial proceedings.

15. If the parties provide for conciliation in the contract, they will have to settle a number of procedural questions in order to increase the chance of a settlement and to avoid some of the potential disadvantages of conciliation, which are mentioned below. Settling such procedural questions is greatly facilitated by the incorporation into the contract, by reference, of a set of conciliation rules such as the UNCITRAL Conciliation Rules.[1] Some countries have adopted legislation that is designed to facilitate the use of conciliation in commercial disputes.

16. A potential disadvantage of conciliation is that, if the conciliation were to fail completely, the money and time spent on it would have been wasted. That disadvantage might be reduced to some extent if the project agreement does not require the parties to attempt conciliation prior to initiating arbitral or judicial proceedings, but merely permit a party to initiate conciliation proceedings. Conciliation would thus take place in cases where there exists a real likelihood of reaching an amicable settlement.

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[1] Report of the United Nations Commission on International Trade Law on the work of its thirteenth session, Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17 (A/35/17), para. 106 (Yearbook of the United Nations Commission on International Trade Law, Vol. XI: 1980, part one, II, A (United Nations publication, Sales No. E.81.V.8)). The UNCITRAL Conciliation Rules have also been reproduced in booklet form (United Nations publication, Sales No. E.81.V.6). Accompanying the Rules is a model conciliation clause, which reads: "Where, in the event of a dispute arising out of or relating to this contract, the parties wish to seek an amicable settlement of that dispute by conciliation, the conciliation shall take place in accordance with the UNCITRAL Conciliation Rules as at present in force." The use of the UNCITRAL Conciliation Rules has been recommended by the United Nations General Assembly in its resolution 35/52 of 4 December 1980.

17. Another potential difficulty may arise from the fact that in conciliation proceedings the parties typically express suggestions and views regarding proposals for a possible settlement, make admissions or indicate their willingness to settle. If, despite such efforts, the conciliation does not result in a settlement and the parties initiate judicial or arbitral proceedings, those views, suggestions, admissions or indications of willingness to settle might be used to the detriment of the party who made them. This possibility may discourage parties from actively trying to reach a settlement during conciliation proceedings, which would reduce the usefulness of conciliation. In order to address the problem, some rules (e.g. art. 20 of the UNCITRAL Conciliation Rules) contain a stipulation according to which the parties undertake not to rely on or introduce as evidence in any subsequent arbitral or judicial proceedings (i) views expressed or suggestions made by the other party in respect of a possible settlement of the dispute; (ii) admissions made by the other party in the course of the conciliation proceedings; (iii) proposals made by the conciliator; (iv) the fact that the other party had indicated its willingness to accept a proposal for settlement made by the conciliator. In order to foster conciliation as a method of settling disputes and to ensure that the described difficulties do not arise, some States have adopted legislative provisions restricting the introduction of certain evidence relating to conciliation proceedings into subsequent judicial or arbitral proceedings.

18. A party may be reluctant to actively strive for a settlement in conciliation proceedings if it has to take into account the possibility that, if the conciliation is not successful, the conciliator might be appointed as counsel of the other party or as an arbitrator. The conciliator's awareness of certain facts occurring during conciliation (e.g. proposals for settlement and admissions) might prove to be prejudicial for the party who made them. This is the reason behind stipulations found in some standard conciliation rules (e.g. art. 19 of the UNCITRAL Conciliation Rules) to the effect that the parties and the conciliator undertake that the conciliator will not act as an arbitrator or as a representative or counsel of a party in any arbitral or judicial proceedings in respect of a dispute that is the subject of the conciliation proceedings; furthermore, the parties undertake that the parties will not present the conciliator as a witness in any such proceedings. Some jurisdictions, with a view to promoting and facilitating conciliation, have enacted legislative provisions limiting the possibility of a conciliator acting in a related subsequent dispute as counsel, an arbitrator or a witness.

19. Nevertheless, prior knowledge on the part of the arbitrator might be regarded by the parties as advantageous, in particular because that knowledge will allow the arbitrator to conduct the case more efficiently. If this is so, the parties may prefer that the conciliator be appointed as an arbitrator in the subsequent arbitral proceedings. In order to overcome any objection based on assertions of prejudice in those cases, some jurisdictions have adopted laws expressly allowing a conciliator, subject to agreement of the parties, to serve as an arbitrator.

20. A further potential disadvantage of conciliation is the possibility that a party would not live up to the settlement reached in conciliation proceedings. Thus, the attractiveness of conciliation would be increased if a settlement reached during a conciliation would be enforceable similarly as an arbitral award, so that a party to the settlement would not be compelled to initiate adversarial arbitral or judicial proceedings in order to enforce the settlement. A way of making a settlement enforceable may be for the parties to appoint the conciliator as an arbitrator and limit the arbitral proceedings to recording the settlement in the form of an arbitral award on agreed terms (as provided for, e.g., in art. 34(1) of the

UNCITRAL Arbitration Rules). A possible obstacle to this approach, however, may arise in legal systems in which, once a settlement has been reached and the dispute thereby eliminated, it is not possible to institute arbitral proceedings. In order to deal with this obstacle, some jurisdictions have adopted laws that establish the enforceability of settlement agreements reached in conciliation. One possible legislative solution may be to provide that the written settlement agreement should, for the purposes of its enforcement, be treated as an arbitral award and may be enforced as such. Another solution may be for legislation to expressly permit the parties to the settlement, despite the disappearance of the dispute, to commence arbitration and obtain from the arbitrator, who may be the former conciliator, an award on agreed terms.

4. Proceedings before a referee or a dispute review board

21. The parties may wish to consider providing for certain types of disputes to be settled by a third party (referred to in the *Guide* as a "referee") or by a board of experts appointed by both parties. These boards of experts are often referred to, for example, as "dispute review boards", "concession referee boards" or "dispute adjudication boards". Proceedings before a referee or a dispute review board can be quite informal and expeditious, and tailored to suit the characteristics of the dispute that they are called upon to settle. In such a process, the parties may be free to accept or reject the suggestions of the referee or dispute review board and to initiate judicial or arbitral proceedings at any time, especially if such initiation is needed in order to prevent the loss or prescription of a right. The appointment of a referee or dispute review board may prevent misunderstandings or differences between the parties from developing into formal disputes requiring settlement in arbitral or judicial proceedings.

22. Where these procedures are used, if a dispute arises which the parties have been unable to resolve by discussion, either party can refer the dispute to the referee or dispute resolution board for a recommendation or adjudication. Such referral triggers an evaluation by the referee or dispute review board, which is done in an informal manner, typically by discussion with the parties during a regular site visit. The referee or the board controls the discussion, but each party is given a full opportunity to state its views, and the referee or dispute review board is free to ask questions, and to request documents and other evidence. The board then meets privately and seeks to reach a unanimous recommendation or adjudication. Typically, according to the contract provisions establishing the referee or the dispute review board mechanism, the decision of the referee or dispute resolution board is not automatically binding on the parties, but they may stipulate that the decision becomes binding unless one or both parties refer the dispute to arbitration or initiate judicial proceedings.

23. A few international organizations and trade associations have developed rules concerning the use of a referee or a dispute review board in the settlement of disputes, but those rules generally deal with only some aspects of the matter. Many legal systems do not regulate proceedings before a referee. Others regulate them only to a very limited extent. It should also be noted that the law applicable to the proceedings may provide only limited legal safeguards to ensure that the proceedings are conducted impartially and with due care. In addition, under many legal systems, the decision by the referee or dispute review board, while binding as a contract, does not constitute an

executory title, since it does not have the status of an arbitral award or a judicial decision. For these reasons, if the parties contemplate providing for proceedings before a referee or dispute review board, it will be necessary for them to settle various aspects of those proceedings in the project agreement. The main issues to be provided are discussed below.

24. The composition of the dispute review board may vary in the different stages of the project. Each board member should be experienced in the type of project, and in contract interpretation and administration for such projects, and should undertake to remain impartial and independent of the parties. In the construction phase, for instance, these persons may be furnished with periodic reports on the progress of construction and informed immediately of differences arising between the parties on matters connected with the construction. They may meet with the parties on the site, either at regular intervals or when the need arises, to consider differences that have arisen and to suggest possible ways of resolving those differences.

25. It would be desirable for the project agreement to delimit as precisely as possible the authority conferred upon the referee or dispute review board. It may specify the functions to be performed by the referee or dispute review board, and the type of issues with which they may deal. It is desirable to restrict the authority of the referee or dispute review board to issues of a predominantly technical character. A possible way of expressing such a restriction in the contract is to include a list of technical issues with which the referee or dispute review board are authorized to deal.

26. With regard to the nature of their functions, the project agreement might authorize the referee or dispute review board to make findings of fact and to order interim measures. The project agreement might also authorize them to change or supplement terms of the project agreement when they may be permitted to do so under the law applicable to the project agreement (see para. 6). The parties may wish to consider whether the referee or dispute review board should be authorized to decide on the substance of certain types of disputes (e.g. disputes as to whether completion tests or performance tests were successful, or as to grounds asserted by the concessionaire for objecting to a variation ordered by the contracting authority), or whether the settlement of those disputes should be left to arbitrators or courts.

27. To the extent they are permitted to do so by the law applicable to the proceedings, the parties might wish to deal in the project agreement with the relationship between proceedings before a referee or dispute review board and proceedings before a court or arbitral tribunal. For example, the project agreement might provide that disputes within the scope of the authority of the referee or dispute review board must first be submitted to it for resolution and that arbitral or judicial proceedings cannot be initiated until the expiration of a specified period of time after submission of the dispute to the referee or dispute review board. The project agreement should further clarify whether the recommendation or adjudication of the dispute review board is admissible as evidence in any subsequent arbitral or judicial proceedings.

28. The law governing arbitral or judicial proceedings may determine the extent to which the parties may authorize arbitrators or a court to review a decision of the referee or dispute review board. Excluding such review has the advantage that the decision of the referee or dispute review

board would be immediately final and binding. However, permitting such a review gives the parties greater assurance that the decision will be correct. The advantages of both approaches may be combined to some extent by providing that the decision by the referee or dispute review board is binding on the parties unless a party initiates arbitral or judicial proceedings within a short specified period of time after the decision is rendered. If they are permitted to do so, the parties might specify that findings of fact made by a referee or dispute review board cannot be challenged in arbitral or judicial proceedings. The project agreement might also obligate the parties to implement a decision by the referee concerning interim measures or a decision on the substance of certain specified issues; if the parties fail to do so, they will be considered as having failed to perform a contractual obligation.

29. Procedures before referees or dispute review boards have been used in conjunction with adversary dispute settlement mechanisms, such as arbitration. These procedures are being increasingly used in countries where government agencies are by law restricted to resolving contractual disputes by court litigation. Early clauses on referees or dispute review boards did not have provisions making their recommendations binding. In practice, however, the combination of the persuasive force of unanimous recommendations by independent experts agreed by the parties led both contracting authorities and project companies to accept voluntarily the recommendations rather than litigate. Apart from avoiding potentially protracted litigation, the parties often take into account the potential difficulty of overcoming what might be regarded by the court or arbitral tribunal as a powerful recommendation, as it had been made by independent experts familiar with the project from the outset, and was based on contemporaneous observation of the project prior to, and at the time of, the dispute having first arisen.

5. Arbitration

(a) Considerations as to whether to conclude arbitration agreement

30. There are various reasons why arbitration is frequently used for settling disputes arising under privately financed infrastructure projects. Arbitral proceedings may be structured by the parties so as to be less formal than judicial proceedings and better suited to the needs of the parties and to the specific features of the disputes likely to arise under the project agreement. The parties can choose as arbitrators persons who have expert knowledge of the particular type of project. They may choose the place where the arbitral proceedings are to be conducted. They can also choose the language or languages to be used in the arbitral proceedings. Where parties agree to arbitration, neither party submits to the courts of the country of the other party, except to the extent the courts of the place of arbitration may be called upon to intervene in the arbitral process. Arbitral proceedings may be less disruptive of business relations between the parties than judicial proceedings. The proceedings and arbitral awards can be kept confidential, while judicial proceedings and decisions usually cannot. Arbitral proceedings tend to be more expeditious and, in view of their finality, often less costly than judicial proceedings. While some legal systems provide for summary judicial proceedings for certain types of disputes (usually disputes involving relatively small sums of money) many disputes arising in connection with a privately financed infrastructure project will not qualify for settlement under such proceedings. Finally, as a result of international conventions that assist in the

recognition and enforcement of foreign arbitral awards, those awards are frequently recognized and enforced more easily than foreign judicial decisions (see also paras. 56-59).

31. On the other hand, an arbitral award may be set aside in judicial proceedings. The initiation of those proceedings will prolong the final settlement of the dispute. However, under most legal systems, an arbitral award may be set aside only on a limited number of grounds, for example that the arbitrators lacked authority to decide the dispute, that a party could not present its case in the arbitral proceedings, that the rules applicable to the appointment of arbitrators or to the arbitral procedure were not complied with, or that the award was contrary to public policy.

(b) Authority to agree on arbitration

32. There are two possible limits to the freedom to agree to arbitration: one arising from the subject matter to be submitted to arbitration and another one arising from the governmental character of a party to the arbitration agreement. In many legal systems, the traditional position has been that the Government and its agencies may not agree to arbitration. This position has often been restricted to mean that it does not apply to public enterprises with an industrial or commercial character which, in their relations with third parties, act pursuant to private law or commercial law.

33. As noted earlier (see chap.I, "General legislative considerations",____), in some legal systems belonging to the civil law tradition, the provision of public services is governed by a body of law known as "administrative law", which governs a wide range of governmental functions. In many of those countries there are special provisions for the settlement of disputes arising out of government contracts; in particular there may exist prohibitions for the government agencies to agree to arbitration to the exclusion of court jurisdiction. Such restrictions may extend to a varying degree to a range of governmental entities encompassing the legislative, administrative and executive branches. However, there may be differences between a contract entered into by a governmental department and one that is entered into by a government-owned corporation. Also to be taken into consideration is the constitutional division of powers within the host country. In some countries, certain matters fall within the exclusive jurisdiction of a subsidiary political division (i.e. a state or province), whereas two or more political divisions may share jurisdiction in respect of other matters. It may not be possible for one of these governmental divisions to preclude the application of laws that govern matters within the jurisdiction of another division.

34. Limitations to the freedom to agree on arbitration may also relate to the legal nature of the project agreement. Under civil law systems with a special category of administrative law, there may be provisions that classify the project agreements as administrative contracts, with the consequence that they are governed by the administrative law of the host State. Under other legal systems, similar prohibitions may be expressly included in legislation or judicial precedents directly applicable to project agreements. But even where there is no overt prohibition, the same result may be achieved by established contract practices in the area of privately financed infrastructure projects, usually based on legislative rules or regulations. For example, legislation may stipulate that governmental contracts are required to adhere to certain standard forms of contract, which may contain standard clauses, including a standard dispute settlement clause which stipulates the jurisdiction of the courts

of the host country. Therefore, regardless of the type of legal regime under consideration, it is important to determine whether a project agreement will be classified as a governmental contract subject to certain rules, as a private commercial contract subject to the same rules as any other such type of contract, or whether there are special rules that apply to project agreements in general (see also chapter IV, "The project agreement", ___).

35. For countries that wish to allow the use of arbitration for the settlement of disputes arising in connection with privately financed infrastructure projects, it is important to remove possible legal obstacles and to provide a clear authorization for domestic contracting authorities to agree to arbitrate their disputes. The absence of a clear legislative authority to agree on arbitration may give rise to questions as to the validity of the arbitration agreement and cause delay in the settlement of possible disputes. Dealing with allegations of invalidity of an arbitration agreement will in the first instance be in the hands of the arbitral tribunal which will have to decide the validity of the allegation. If the arbitral tribunal finds that the arbitration agreement has been validly concluded despite any subsequent defence that the contracting authority had no authorization to conclude it, the question may reappear at the recognition and enforcement stage before a court in the host country or before a court of a third country where the award is to be recognized or enforced.

36. With regard, in particular, to infrastructure projects involving foreign investors, it may be noted that a framework for the settlement of disputes between the contracting authority and foreign companies participating in a project consortium may be provided by a bilateral investment treaty or by adherence to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (Washington, 1965). The Convention, which has thus far been adhered to by 139 States, established the International Centre for the Settlement of Investment Disputes (ICSID). ICSID provides facilities for the conciliation and arbitration of disputes between member countries and investors who qualify as nationals of other member countries. Recourse to ICSID conciliation and arbitration is voluntary. However, once the parties to a contract or dispute have consented to arbitration under the ICSID Convention, neither can unilaterally withdraw its consent. All ICSID members, whether or not parties to the dispute, are required by the Convention to recognize and enforce ICSID arbitral awards. ICSID is an autonomous international organization with close links with the World Bank.

(c) Provisions of arbitration agreement

(i) Scope of arbitration agreement and mandate of arbitral tribunal

37. In general, arbitral proceedings may be conducted only on the basis of an agreement by the parties to arbitrate. The agreement may be reflected either in an arbitration clause included in the project agreement or in a separate arbitration agreement concluded by the parties before or after a dispute has arisen. Since it may be more difficult to reach an agreement to arbitrate after a dispute has arisen, it is advisable either to include an arbitration clause in the project agreement or to enter into a separate arbitration agreement at the time of entering into the contract. However, under some legal systems, an agreement to arbitrate is procedurally and substantively fully effective only if it is concluded after a dispute has arisen.

38. It would be advisable for the project agreement to indicate what disputes are to be settled by arbitration. For example, the arbitration clause may stipulate that all disputes arising out of or relating to the project agreement or the breach, termination or invalidity thereof are to be settled by arbitration. In some cases, the parties may wish to exclude from that wide grant of jurisdiction certain disputes that they do not wish to be settled by arbitration.

39. If permitted under the law applicable to the arbitral proceedings, the parties may wish to authorize the arbitral tribunal to order interim measures pending the final settlement of a dispute. However, under some legal systems, arbitral tribunals are not empowered to order interim measures even if so authorized by the parties. Under other legal systems, where interim measures can be ordered by an arbitral tribunal, in many cases they cannot be enforced, although also unenforceable measures are not without practical value. In those cases, it may be preferable for the parties to rely on a court to order interim measures. Under many legal systems, a court may order interim measures even if the dispute is to be or has been submitted to arbitration.

40. It is desirable for the arbitration agreement to obligate the parties to implement arbitral decisions, including decisions ordering interim measures. The advantage of including such an obligation in the project agreement is that under some legal systems, where an arbitral award is not enforceable in the country of a party, a failure by the party to implement an award when obligated to do so by the contract might be treated in judicial proceedings as a failure by the party to perform a contractual obligation.

41. If judicial proceedings are instituted in respect of a dispute covered by an arbitration agreement that is recognized to be valid, upon a timely request the court will normally refer the dispute to arbitration. However, the court may retain the authority to order interim measures and will normally be entitled to control certain aspects of arbitral proceedings (e.g. to decide on a challenge to arbitrators) and to set aside arbitral awards on certain grounds (see paras. 56-59).

(ii) Type of arbitration and appropriate procedural rules

42. The parties are able to select the type of arbitration that best suits their needs. It is desirable that they agree on appropriate rules to govern their arbitral proceedings. There is a wide range of arbitration systems available, with varying degrees of involvement of permanent bodies (e.g. an arbitration institution, professional or trade association or chamber of commerce) or third persons (e.g. a chief officer of a court of arbitration or of a chamber of commerce). At one end of the spectrum is the pure ad hoc type of arbitration, which does not involve a permanent body or third person in any way. This means, in practical terms, that no outside help is available (except, perhaps, from a national court) if, for example, difficulties are encountered in the appointment or challenge of an arbitrator. Moreover, any necessary administrative arrangements have to be made by the parties or the arbitrators themselves. At the other end of the spectrum there are arbitrations fully administered and supervised by a permanent body, which may review terms of reference and the draft award and may revise or make recommendations as to the form of the award.

43. Between these two types of arbitration there is a considerable variety of arbitration systems, all of which involve an appointing authority (or at least a system for the appointment of the appointing authority, as provided for by the UNCITRAL Arbitration Rules). These systems differ as to the administrative services that they provide. The essential, although not necessarily exclusive, function of an appointing authority is to compose or assist in composing the arbitral tribunal (e.g. by appointing the arbitrators, deciding on challenges to an arbitrator or replacing an arbitrator). Administrative or logistical services, which may be offered as a package or separately, could include the following: forwarding written communications of a party or the arbitrators; assisting the arbitral tribunal in organizing hearings and other meetings (including notifying the participants; providing, or arranging for, meeting rooms for hearings or deliberations of the arbitral tribunal; arranging for maintaining a record of hearings and for interpretation during hearings and possibly translation of documents); assisting in filing or registering the arbitral award, when required; holding deposits and administering accounts relating to fees and expenses; and providing other secretarial or clerical assistance.

44. Unless the parties opt for pure ad hoc arbitration, they may wish to agree on the body or person to perform the functions that they require. Among the factors worthwhile considering in selecting an appropriate body or person are the following: willingness to perform the required functions; competence, in particular in respect of international matters; appropriateness of fees measured against the extent of services requested; seat or residence of the body or person and possible restriction of its services to a particular geographic area. The latter point should be viewed in conjunction with the probable or agreed place of arbitration. However, certain functions (e.g. appointment) need not necessarily be performed at the place of arbitration, and certain arbitral institutions are prepared to provide services in countries other than those where they are located.

45. In most cases, the arbitral proceedings will be governed by the law of the State where the arbitration takes place. Many States have laws regulating various aspects of arbitral proceedings. Some provisions of these laws are mandatory; others are non-mandatory. In selecting the place of arbitration, the parties may wish to consider the extent to which the law of a place under consideration recognizes the special needs and features of international commercial arbitration and, in particular, whether it allows the parties to tailor the procedural rules to meet their particular needs and wishes while at the same time ensuring that the proceedings are fair and efficient. A trend in this direction, discernible from modern legislation in a good number of jurisdictions, is being enhanced and fortified by the UNCITRAL Model Law on International Commercial Arbitration, which was adopted in 1985.[2]

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[2] Report of the United Nations Commission on International Trade Law on the work of its eighteenth session, Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17), para. 332 and Annex I. The United Nations General Assembly, in its resolution 40/72 of 11 December 1985, recommended "that all States give due consideration to the Model Law on International Commercial Arbitration, in view of the desirability of uniformity of the law of arbitral procedures and the specific needs of international commercial arbitration practice".

46. Since the arbitration laws of some States are not necessarily suited to the particular features and needs of international commercial arbitration, and since, in any case, those laws do not contain rules settling all procedural questions that may arise in relation to arbitral proceedings, the parties may wish to agree on a set of arbitration rules to govern arbitral proceedings. When the parties choose to have their arbitration administered by an institution, the institution usually requires the parties to use the rules of that institution, and would refuse to administer a case if the parties have modified provisions of those rules that the institution regards as fundamental to its arbitration system. Many arbitral institutions offer a choice of two or sometimes more sets of rules and usually allow the parties to modify the rules, in particular those rules that do not interfere with the administration of the arbitration by the institution. If the parties are not required by an institution to use a particular set of arbitration rules or to choose among specified sets of rules, or if they choose ad hoc arbitration, they are free to choose a set of rules themselves. In selecting a set of procedural rules, the parties may wish to consider its suitability for international cases and the acceptability of the procedures contained in them.

47. Of the many arbitration rules promulgated by international organizations or arbitral institutions, the UNCITRAL Arbitration Rules[3] deserve particular mention. These Rules have proven to be acceptable in different legal, social and economic systems and are widely known and used in all parts of the world. Parties may use them in pure ad hoc arbitrations as well as in arbitrations involving an appointing authority with or without the provision of additional administrative services. A considerable number of arbitration institutions in all regions of the world have either adopted these Rules as their own institutional rules for international cases or have offered to act as appointing authority. Most of them will provide administrative services in cases conducted under the UNCITRAL Arbitration Rules.

(iii) Practical matters to be settled by parties

48. The provisions on arbitration in the project agreement or in a separate arbitration agreement should also deal with a number of practical matters, such as: the number of arbitrators who are to comprise the arbitral tribunal; the procedures for appointing the arbitrators; the place where the proceedings are to be held and where the arbitral award is to be issued; the language to be used in the arbitral proceedings.

49. Where a model clause accompanies the arbitration rules or is suggested by an arbitral institution, adoption of that clause by the parties enhances the certainty and effectiveness of the arbitration agreement. Some model clauses, such as the one accompanying the UNCITRAL Arbitration Rules, suggest that the parties settle these practical matters by agreement.

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[3] Report of the United Nations Commission on International Trade Law on the work of its ninth session, Official Records of the General Assembly, Thirty-first Session, Supplement No. 17 (A/31/17), para. 57 (Yearbook of the United Nations Commission on International Trade Law, Vol. VII: 1976, part one, II, A (United Nations publication, Sales No. E.77.V.1)). The UNCITRAL Arbitration Rules have also been reproduced in booklet form (United Nations publication, Sales No. E.77.V.6). The use of the UNCITRAL Arbitration Rules has been recommended by the United Nations General Assembly in its resolution 31/98 of 15 December 1976.

(d) Particular issues concerning the implementation of arbitration agreements

50. If it is found desirable to allow the parties the freedom to choose the dispute settlement mechanism, including arbitration, it is advisable to consider whether express legislative authority is required. Such express authority would be needed where, given the tradition of exclusive court jurisdiction in matters of governmental concessions, arbitration is not permitted or it may be uncertain whether the parties to a project agreement are free to agree to arbitration.

(i) Sovereign immunity

51. When arbitration is allowed and agreed upon between the parties to the project agreement, the implementation of an agreement to arbitrate may be frustrated or hindered if the State entity is able to plea State immunity, either as a bar to the commencement of arbitral proceedings or as a defence against recognition and enforcement of the award. Sometimes the law on this matter is not clear, which may raise concerns with the investors and the party concluding a contract with the contracting authority that an agreement to arbitrate might not be effective. In order to allay such possible concerns, it is advisable to review the law on this topic and indicate the extent to which the contracting authority may raise a plea of sovereign immunity.

52. Applying concepts of private law to the extent they may be applied to the question whether State immunity may be raised as a bar to the commencement of arbitral proceedings, or applying principles developed in legislation and case law of some States, an agreement to arbitrate may be regarded as a waiver of the State immunity.

53. Even if the award has been issued against the contracting authority it may raise a plea of immunity from execution against State property. There is a diversity of approaches to the question of State immunity from execution. For example, under some national laws immunity does not cover State entities engaged in commercial activity. In other national laws a link is required between the property to be attached and the claim in that, for example, immunity cannot be pleaded in respect of funds allocated for economic or commercial activity governed by private law upon which the claim is based or that immunity cannot be pleaded with respect to assets set aside by the State to pursue its commercial activities. In some States it is considered that it is for the State to prove that the assets to be attached are in non-commercial use.

54. In some contracts involving entities that might plea sovereign immunity, clauses have been included to the effect that the State waives its right to plea sovereign immunity. Such consent or waiver might be contained in an international agreement or the consent may be limited to recognizing that certain property is used or intended to be used for commercial purposes. Such written clauses have been used inasmuch as it is not clear whether the conclusion of an arbitration agreement and participation in arbitral proceedings by the State entity constitutes an implied waiver of sovereign immunity from execution.

55. The legislator may wish to review its laws on this matter and, to the extent considered advisable, clarify in which areas State entities may not plea sovereign immunity.

(ii) Enforceability of the award

56. The effectiveness of an agreement to arbitrate depends also on legislation governing the recognition and enforcement of arbitral awards. These legislative provisions have been harmonized by the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958),[4] which, inter alia, deals with the recognition of an arbitration agreement and the grounds on which the court may refuse to recognize or enforce an award. The Convention has been adhered to by a large number of countries and is widely regarded as providing an acceptable and balanced regime for the recognition and enforcement of arbitral awards. The fact that the host country is a party to the Convention is likely to be seen as a crucial element in assessing the legal certainty of binding commitments and of the reliability of arbitration as a method for solving disputes by arbitration with parties from the country.

57. According to its article I, the Convention applies to the recognition and enforcement of awards "made in the territory of a State other than the State where the recognition and enforcement of such awards are sought". Thus, if the place of arbitration is in the host country, the courts of that country will normally not apply the Convention to awards made there even if the host country is a party to the Convention. The applicability of a recognition and enforcement regime other than that of the Convention may be seen as a factor increasing the uncertainty of arbitration as a dispute settlement mechanism. In order to avoid that uncertainty, the project company may be interested in reaching an agreement with the contracting authority that any arbitration take place in a country other than the host country.

58. In order to increase the attractiveness of the host country as the venue for arbitration, the legislator may decide to adopt a regime for the recognition and enforcement of arbitral awards made in the State that is essentially the same as the regime set forth in the Convention. Such a regime is contained in the UNCITRAL Model Law on International Commercial Arbitration, which is closely modelled on the 1958 New York Convention and which applies to all awards whether they have been made in the enacting State or in a foreign State. The internationally harmonized wording of the relevant provisions of the Model Law will increase the transparency of the law in the host country on this point.

59. The applicability in the host country of the 1958 New York Convention and the regime modelled on that Convention for the awards not covered by the Convention does not eliminate all possibilities of frustrating recognition and enforcement of an award issued in the host country. This is because a party may apply to the courts of the place where the award has been made to set aside

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[4] See United Nations Treaties Series, Vol. 330, p. 38, No. 4739 (1959), reproduced in Register of Conventions and other Instruments concerning International Trade Law, Vol. II (United Nations publication, Sales No. E.73.V.3).

the award. The effectiveness of arbitration will thus also depend on the legislative regime for the setting aside of awards in the country where the arbitration takes place. If that regime in the host country is seen as unsatisfactory, in particular if it allows an award to be set aside for reasons that go beyond those widely regarded as acceptable for international commercial arbitration, a party might, for that reason, wish to agree on a place of arbitration outside the host country. In order to reassure all parties and in particular private investors that an award made in the host country will not be set aside for exorbitant reasons, the host country may wish to consider adopting a regime that is widely regarded as appropriate for international commercial cases. Such a regime is contained in the UNCITRAL Model Law on International Commercial Arbitration.

6. Judicial proceedings

60. Apart from the question of how the matter is regulated by law, in considering whether any dispute should be resolved in judicial proceedings or whether an arbitration agreement should be entered into, factors typically taken into account by the parties include, for example, their confidence that the courts competent to decide a dispute will be unbiased and that the dispute will be resolved without inordinate delay. The efficiency of the national judicial system and the availability of forms of judicial relief that are adequate to disputes that might arise under the project agreement are additional factors to be taken into account. A potential for delay in court proceedings may arise in particular from the possibilities of recourse against a court decision. Furthermore, in view of the fact that infrastructure projects usually involve highly technical and complex issues, the parties will also consider the implications of using arbitrators selected for their particular knowledge and experience as compared to the judicial system which is typically not based on the idea that a dispute should be entrusted to a judge that has the specific prior knowledge or experience in the area where the dispute arose. Another consideration may be the confidentiality of arbitration proceedings, relative informality of arbitral procedures, and the possibly greater flexibility arbitrators may have in awarding appropriate remedies, all of which may be beneficial for preserving and developing the long-term relationship implicit in project agreements.

61. The contracting authority may see several reasons for leaving any dispute to be resolved by the courts of the host country. Those courts are familiar with the law of the country, which often includes specific legislation directly applicable to the project agreement. Furthermore, the contracting authority and other governmental agencies of the host country that might be involved in the dispute may prefer local courts because of the familiarity with the court procedures and the language of the proceedings. It may also be considered that, to the extent project agreements involve issues of public policy and the protection of public interest, state courts are in a better position to give them proper effect.

62. However, such a view by the contracting authority is often not shared by the project company, investors, financiers and other private parties involved in the project. These parties may be concerned that a court of the host country might be biased in favour of the contracting authority or that in court proceedings short term policies or political considerations might prevail over the legitimate interests of the private investors. They may also consider that arbitration is preferable to judicial proceedings because arbitration, being to a larger degree subject to agreement of the parties

than judicial proceedings and not subject to lengthy appeals, is in a position to resolve a dispute more efficiently. Another reason may be that a number of persons on the side of the project company may not be familiar with the language of the court proceedings, which would be a hindrance in their participation in court proceedings.

63. Some countries, including those with a tradition of exclusive jurisdiction of courts in issues arising from governmental concessions, have concluded that there are no compelling reasons of public interest for not allowing the parties to the project agreement to agree on the dispute settlement mechanism they consider the most appropriate. In some countries it was also found that allowing the parties to choose the dispute settlement mechanism helped to attract foreign investment for the development of its infrastructure.

64. However, according to other laws, agreement to arbitrate is not allowed, with the result that the provisions on competence of courts of the host country apply. In countries where Government contracts are subject to such a special regime, it may be advisable for the legislature to review the adequacy of the provisions on dispute settlement for privately financed infrastructure projects.

C. Settlement of commercial disputes

1. General remarks

65. In addition to the project agreement, there are various other contracts involved in a privately financed infrastructure project. The legislative considerations underlying any regulation of dispute settlement mechanisms would depend on the types of contract and the characteristics of disputes that may arise therefrom. These contracts would typically include the following: (a) agreements and corporate instruments entered into by project sponsors; (b) financing and related agreements; (c) construction contracts; (d) operation and maintenance contracts; (e) contracts for the supply of goods and services needed for the operation and maintenance of the facility.

66. It is generally accepted in national laws that parties to commercial transactions, and in particular international commercial transactions, are free to agree on the forum that will decide in a binding decision any dispute that may arise from those transactions. In international transactions, arbitration has become the preferred method, whether or not it is preceded by, or combined with, conciliation. As to contracts usually forming part of privately financed infrastructure transactions, in many countries the parties are free to subject disputes to arbitration, to select the place of arbitration and to determine whether or not any arbitration case should be administered by an arbitral institution. This is true in particular for the types of contract mentioned in the preceding paragraph. These contracts are generally considered commercial agreements to which, as regards disputes settlement clauses, general rules regarding commercial contracts are applicable. Governments wishing to establish a hospitable legal climate for privately infrastructure projects would be advised to review their laws with respect to these contracts so as to eliminate any uncertainty regarding the freedom of the parties to agree to dispute settlement mechanisms of their choice.

2. Specific types of contracts and disputes

(a) Agreements and corporate instruments entered into by project sponsors

67. These agreements may include, in addition to the instruments of incorporation of the project company, for example, various shareholders' agreements, agreements regarding the provision of additional financing or arrangements regarding voting rights. Parties to these instruments and agreements typically have a strong tendency to resolve their disputes by voluntary conciliation rather than in formal arbitral or court proceedings.

(b) Financing and related agreements

68. Since only a minor part of financing is provided directly by project sponsors and the rest is obtained from various lenders and investors, a number of credit agreements, export credit arrangements and other financing instruments are entered into with parties such as commercial banks, governmental lending institutions, international lending institutions and export credit insurers. The lenders pay particular attention to legal certainty, enforceability of financial obligations as well as to legal validity of security arrangements. Lenders have a tendency of favouring agreements that submit any disputes arising out of these agreements to the court jurisdiction of international financial centres. However, lending instruments in some privately financed infrastructure projects have provided for arbitration as a method for settling these types of disputes.

(c) Construction contracts

69. Contracts for the construction of the facility are often concluded by the project company on a turnkey basis, either with one contractor or a consortium of contractors, under a single contract or several contracts.[5] Members of the consortium of contractors may in turn enter into a number of additional agreements among themselves regarding, for example, the supply of equipment and the provision of various services.

70. Experience shows that construction contracts are particularly prone to disputes and these disputes present problems that do not often exist in other types of contract. This is due, for example, to the technical complexity of these contracts, the number of different enterprises that participate in the construction, need for variations or far-reaching consequences of mistakes.

71. It is often desirable for disputes arising under construction contracts to be settled by arbitration. However, certain disputes that may arise under the construction contracts are not within the legal competence of courts or arbitral tribunals or cannot conveniently be settled in arbitral or judicial proceedings (for example, disputes of a technical nature that need to be resolved more speedily than is possible in arbitral or judicial proceedings). The parties may wish to provide for

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[5] For a description of contracting approaches in the construction industry, see the *UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works*, chapter II.

such disputes to be dealt with by a third party, such as a referee or a dispute review board (see also paras. 21-29).

72. Disputes involving several enterprises may arise in connection with the construction. For example, where the project company alleges that the construction is defective, it may be uncertain which of several contractors engaged by it is liable. If the project company pursues individual claims against each contractor and those claims are settled in separate proceedings by different courts or arbitrators, those proceedings may result in inconsistent decisions. This could occur even if the same law governs all of the contracts and could result, for example, from the application of different procedural rules or from different evaluations of the relevant evidence. Settlement of all related claims in the same proceedings could prevent inconsistent decisions, facilitate the taking of evidence, and reduce costs. However, multi-party proceedings tend to be more complicated and less manageable, and a party may find it more difficult to plan and present its case in such proceedings. Many legal systems provide means for disputes involving several parties to be settled in the same multi-party judicial proceedings. In order to enable disputes involving several enterprises to be settled in multi-party judicial proceedings, it may be desirable for all contracts entered into by the project company for the construction of the works to contain a clause conferring exclusive jurisdiction on a court which has the power to conduct multi-party proceedings. It is more difficult to structure multi-party proceedings when arbitration is to be used for the settlement of disputes. However, some of the benefits of multi-party proceedings might be achieved if the same arbitrators were appointed to settle disputes arising under all contracts concerning the construction of the works.

73. Under some legal systems, a party seeking to consolidate arbitral proceedings before one single arbitral tribunal may file an application for that purpose to a court. In most of those legal systems such an application must be based on the consent of all parties concerned. In some of these jurisdictions, application for consolidation can be made to the arbitral tribunal or tribunals concerned. The requested arbitral tribunals may confer with each other with a view to making consistent orders for consolidation. If an order for consolidation is not made, or if inconsistent provisional orders by the arbitral tribunals involved are made, any party may apply to the court, which will decide on consolidation. In most legal systems that contain specific provisions on this matter, a consolidation order can be made where there is a common question of law or fact, that the rights to relief claimed arise out of the same transaction or that for some other reason a consolidation order is desirable.

(d) Contract or contracts between the project company and the party who operates and maintains the project facility

74. Disputes arising from contracts for the operation and maintenance of the project facility frequently present problems that do not often exist in disputes arising under other types of contracts. This is due to their complexity, the fact that they are to be performed over a long period of time and the fact that a number of enterprises may participate in the operation and maintenance of the project. In addition, there is a strong public interest in the timely and proper performance of these contracts. Disputes under these contracts often concern highly technical matters connected with the construction processes and with the technology incorporated in the project. It is particularly important that they be settled speedily in order not to disrupt the maintenance of the facility or the provision of the public

service. These considerations ought to be taken into account by the parties in determining the most suitable dispute settlement mechanisms.

75. As with disputes that relate to the construction phase, disputes arising in connection with the operation of the infrastructure, too, may involve several enterprises and the earlier considerations concerning multi-party proceedings would also apply *mutatis mutandis* in this context (see paras. 72-73).

(e) Contracts for the supply of goods and services needed for the operation and maintenance of the facility

76. Contracts for the supply of goods and services needed for the operation and maintenance of the facility, as usual commercial contracts, do not pose any particular considerations in the context of privately financed infrastructure projects. However, to the extent that a governmental agency of the host country is a party to any of these contracts, considerations similar to those concerning disputes between the contracting authority and the concessionaire (see paras. 4-64) may also be relevant in this context.

D. Disputes involving other parties

1. Disputes between the concessionaire and its customers

77. Depending on the type of project, the concessionaire's customers may include various persons and entities, such as, for example, a government-owned utility company that purchases electricity or water from the concessionaire so as to resell it to the ultimate users; commercial companies, such as airlines or shipping lines contracting for the use of the airport or port; or individual persons paying for the use of a toll road. The considerations and policies regarding contracts with the end-purchasers of the goods or services supplied by the project company depend on who are the parties to those contracts. If the end-users are utility companies or commercial enterprises, the parties would settle any disputes by methods usual in trade contracts, including arbitration. If, however, the users are consumers, i.e. individual persons acting in their non-commercial capacity, special considerations may apply. For example, in some countries it was considered desirable to establish by law an obligation to make available to consumers special simplified and efficient mechanisms for settling disputes with the operator of the facility. Where such special mechanisms exist, it is often provided that the mechanisms are optional without prejudice to the consumers' access to courts.

78. In some countries provisions exist regulating disputes between providers of public services, such as utilities, and purchasers or users of those services. Such special regulation is typically limited to certain industrial sectors and applies to purchases of goods or services by individual consumers; the regulation, for example, provides an obligation of the supplier to establish a mechanism for receiving and dealing with complaints by individual consumers and in some cases also for simplified methods for settling disputes. These methods may include arbitration and conciliation. Typically, such mechanisms are optional for the consumer and do not preclude resort by the aggrieved persons

to courts. Where the purchasers or users are commercial entities, it is usually considered that there is no need for specific regulation of the settlement of disputes.

79. The need for such special provisions in the area of privately financed infrastructure projects and the nature of dispute settlement mechanisms provided for depend on considerations such as the types of goods or services involved, the entities or persons purchasing them and the policies underlying various industrial sectors. It therefore appears advisable to leave any such regulation to sector specific laws or to regulations issued pursuant to such laws.

2. Procedures for solving disagreements between the regulatory body and the concessionaire

80. As noted earlier (see chap. V, "Infrastructure development and operation", ___), during the operational phase of the project the project company will have to comply with a wide variety of conditions and standards for the operation and maintenance of the facility, which are spelled out in the law, regulations or the project agreement. In addition to those obligations, many countries have established a regulatory regime whereby the contracting authority or an independent regulatory body exercises an oversight function over the operation of the facility and the compliance by the project company with the various conditions, standards and decisions taken by the regulatory body. Such regulatory regimes are usually established for particular industrial sectors, such as power generation, water treatment and sanitation or public transportation.

81. The main features of various regulatory systems, institutional mechanisms and regulatory procedures, including the issue of autonomy of the regulatory body vis-à-vis the Government, have been discussed elsewhere in the *Guide* (see chap.I, "General legislative considerations", ___). Irrespective of whether the primary regulatory decisions are made by a governmental department (such as a ministry) or an independent regulatory body, there is a need for a mechanism whereby the operator of the facility may request a review of regulatory decisions in case of disagreements between the regulatory body and the operator. As with the whole regulatory process, a high degree of transparency and credibility is essential. To be credible, the review should be entrusted to an entity that is independent from the regulatory body taking the original decision, from the political authorities of the host country and from the regulated companies.

82. In many legal systems, review of decisions of regulatory bodies is in the jurisdiction of courts. However, if there are concerns over the judicial process of review (e.g. as regards possible delays or the capacity of courts to make evaluations in complex economic issues involved in regulatory decisions) it may be more appropriate to entrust review functions to another body, at least in the first instance, before a final recourse to courts. In some countries, requests for review are considered by a high-level cross-sectoral independent oversight body. There are also countries where requests for review are heard by a panel composed of persons holding specified judicial and academic functions. As to the grounds on which a request for review may be based, in many cases there are limits, in particular as to the right of the appellate body to substitute its own discretionary assessment of facts for the assessment of the body whose decision is being reviewed.

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